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WHICH CAME FIRST, THE FRAUD OR THE MARKET: IS THE FRAUD-CREATED-THE-MARKET THEORY VALID UNDER RULE 10B-5?

*Peter J. Dennin**

> It is true that you may fool all the people some of the time; you can even fool some of the people all the time; but you can't fool all of the people all the time.[1]

INTRODUCTION

In 1999, Joe Loofbourrow, president and founder of American Space Corp. ("ASC"),[2] attempted to raise over one million dollars in a public offering[3] issued over the Internet. The effort was based on misrepresentations on the company's website of plans to build a massive aerospace manufacturing facility, to create a research center in space that would discover every cure to every disease, and other commercialized space activities.[4] These fantastic claims, however, were completely fictional.[5] ASC had no physical offices, no contracts with any potential client or supplier, and Loofbourrow had no experience in the aerospace field.[6] Additionally, there was no plan to

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1. Abraham Lincoln, To a caller at the White House, From Alexander K. McClure, Lincoln's Yarns and Stories (1904), *reprinted in* John Bartlett, Familiar Quotations 451 (16th ed., 1992).

2. *In re* Joe Loofbourrow, Exchange Act Release No. 41,631 (July 21, 1999), *available at* http://www.sec.gov/litigation/admin/34-41631.htm.

3. A public offering is the sale of a security available to the general public. Black's Law Dictionary 1111-12 (7th ed. 1999).

4. *In re* Joe Loofbourrow, Exchange Act Release No. 41,631 (July 21, 1999), *available at* http://www.sec.gov/litigation/admin/34-41631.htm. ASC was both selling "financial partner" interests and offering "free stock," supposedly valued at one dollar per share. *Id.* Fortunately, while many individuals signed up for the free stock, no investors actually purchased any of the offered securities. *Id.* Loofbourrow later admitted in his Offer of Settlement with the Securities and Exchange Commission, that there was no basis for his valuation of the stock. *See id.*

5. *Id.*

6. *Id.*

operate ASC as a legitimate enterprise at any time.[7] ASC's unsuccessful public offering was apparently a complete sham.

If investors had lost money and subsequently tried to pursue a private cause of action for securities fraud under Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act")[8] against ASC or Joe Loofbourrow, in some jurisdictions plaintiffs would have to demonstrate reliance on the company's misrepresentations. In a class action scenario, each member would therefore have to independently prove his or her respective reliance, making class certification onerous, if not impossible.[9] Other jurisdictions, however, recognize the fraud-created-the-market theory, which presumes reliance on the misrepresentations and therefore makes class certification a realistic method of recovery.

Under the fraud-created-the-market theory, investors may rely on the presence of the securities in the market as an indication that the securities are marketable, rather than relying on disclosure statements.[10] "Unmarketable" securities are those issued only because of the issuer's intentional fraud.[11] The fraud-created-the-market theory was established to allow investors to recoup losses incurred in the primary markets,[12] rather than only in efficient secondary markets.[13]

Congress created the Securities and Exchange Commission ("SEC") in the aftermath of the 1929 stock market crash to regulate the entry and conduct of participants in the market.[14] It was charged with the primary responsibility of policing the securities markets for fraudulent offerings, trading irregularities, and market manipulation, as well as any other activity that undermines the integrity of the

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7. *Id.*

8. 17 C.F.R. § 240.10b-5 (2000). For the complete text of Rule 10b-5, *infra* note 39.

9. Class certification is the process under Federal Rule of Civil Procedure 23, which allows for a significant number of plaintiffs or defendants to bring or defend against one lawsuit. *See* Jack H. Friedenthal, et al., Civil Procedure 736-37, 759-63 (3d ed. 1999).

10. *Infra* notes 34, 102 (explaining disclosure statements).

11. *Infra* text accompanying notes 107-08.

12. *Infra* note 31 (defining primary markets).

13. Plaintiffs are allowed to presume reliance in efficient secondary markets under the fraud-on-the-market theory. *See infra* Part I.B.2. For a definition of secondary market, see *infra* note 32.

14. Thomas Lee Hazen, The Law of Securities Regulation 6-9 (3d ed. 1996); *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385, 407-60 (1990) (providing a detailed description of the creation of the Securities Act of 1933 and the Exchange Act, focusing on the Exchange Act); David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 Fordham L. Rev. 1781, 1783-85 (2000) (providing an overview of the history of Rule 10b-5).

market.[15] Although other regulatory bodies, such as NASD Regulation, Inc.,[16] work in conjunction with the SEC, it is still impossible for the SEC to prevent or later prosecute every fraudulent activity in the market.[17] Accordingly, private causes of action expand the remedies available to defrauded investors.

Private causes of action under Rule 10b-5 of the Exchange Act have developed through the courts over the last fifty-five years.[18] The Supreme Court has stated "that private enforcement of [SEC] rules may '[provide] a necessary supplement to [SEC] action,'" and has developed the law with an eye toward providing investors-turned-private-plaintiffs with a flexible method of pursuing relief for their injuries.[19] As a result, while a plaintiff once had to prove the defendant's fraudulent intent, material misstatement or omission, causation, and specifically, the plaintiff's reliance on the defendant's wrongful act in effecting the transaction, courts have eased the plaintiff's burden by presuming reliance in certain situations.[20] Two universally accepted presumptions of reliance are the *Affiliated Ute* presumption[21] and the fraud-on-the-market theory,[22] both of which the Supreme Court has affirmed. A derivative of the fraud-on-the-market theory is the fraud-created-the-market theory, which several federal circuits have adopted.[23]

The fraud-created-the-market theory allows a court to presume reliance if the plaintiff has relied on the market itself to prevent the entry of unmarketable securities.[24] In other words, if not for the

15. *See supra* note 14 (discussing the responsibilities of the SEC).

16. NASD Regulation, Inc. ("NASDR") is the regulatory arm of the National Association of Securities Dealers, better known as the NASD. NASDR is a self-regulatory agency that has jurisdiction over the thousands of registered broker-dealers as well as the NASDAQ over-the-counter-market. NASD Regulation, Who We Are, *available at* http//www.nasdr.com/2200.htm; *see also infra* note 32 (discussing over-the-counter markets).

17. *See infra* notes 338-39 and accompanying text.

18. *See infra* notes 40-45 and accompanying text.

19. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (second alteration in original). The Court reinforced its position thirteen years later in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), stating that private causes of action are "an essential tool for enforcement of the 1934 Act's requirements." *Id.* at 231.

20. *See infra* notes 46-50 and accompanying text (discussing the various aspects of a private plaintiff's burden of proof); *infra* notes 55-57 and accompanying text (discussing the reliance requirement in Rule 10b-5 private causes of action).

21. The *Affiliated Ute* presumption of reliance is based upon the premise that if an issuer intentionally fails to disclose material information regarding itself, a private plaintiff injured by that omission need not establish actual reliance, because reliance is presumed by the court. *See infra* Part I.B.1 for discussion.

22. Under the fraud-on-the-market theory, the court presumes reliance if the defendant materially and intentionally misrepresented information that affected the market price of the security, which in turn caused the plaintiff's loss because of the plaintiff's reliance on the ability of the market to provide a valid price. *See infra* Part I.B.2 for discussion.

23. *Infra* Parts I.C, II.A.

24. *Infra* notes 108-09 and accompanying text.

defendant's fraud, there would be no market for that security to be issued into and subsequently traded upon because the security has no underlying value. The federal circuit courts are currently split on whether to accept the theory as a valid presumption of reliance. Certain circuits hold that plaintiffs may validly rely on the market to prevent such fraud, while other circuits fear that such a presumption contradicts the original intent of the Securities Act of 1933 ("Securities Act") and the Exchange Act (collectively the "Acts") to simply provide disclosure to investors without guaranteeing a security's value.[25] These circuits also fear that such a presumption of reliance will potentially open the floodgates for plaintiffs to bring such suits. Moreover, even those circuits that apply the theory differ in their applications.[26] The Supreme Court has yet to rule on this issue.

This Note discusses whether, in private plaintiff causes of action for securities fraud under Section 10(b) and Rule 10b-5 of the Exchange Act,[27] the fraud-created-the-market theory is a valid presumption of reliance. Part I provides background information on Rule 10b-5 of the Exchange Act and, in particular, it discusses the requirement of plaintiffs to prove reliance, the creation by the courts of the initial presumption of reliance theories as precursors to the fraud-created-the-market theory, and the Fifth Circuit's development of the fraud-created-the-market theory. Part II examines the subsequent decisions that have led to the circuit split, while analyzing the variations in the courts' applications of the theory. Part III argues that the theory, as applied by the Fifth and Tenth Circuits, is both valid and necessary to ensure the original purpose of the Exchange Act, because it provides investors with a flexible mechanism for combating securities fraud. In addition, the circuits that ostensibly reject the theory may be misapplying it. Finally, this Note contends that the continued existence of scams and fraudulent investment schemes, exacerbated by the ease with which such activity can be perpetrated on the Internet, in addition to conventional methods, has made the fraud-created-the-market theory a necessary tool for plaintiffs' recovery.

25. For a discussion of the courts accepting the fraud-created-the-market theory, see *infra* Parts I.C, II.A. For a discussion of the courts rejecting the theory, see *infra* Part II.B.

26. *See infra* Parts II.A-B.

27. *See infra* notes 36, 39 (providing the complete text of Section 10(b) and Rule 10b-5).

I. THE HISTORY OF SECTION 10 AND RULE 10B-5 OF THE EXCHANGE ACT

A. *General History of Rule 10b-5*

In the wake of the 1929 stock market crash, Congress passed the Securities Act and the Exchange Act.[28] In effecting such legislation, Congress intended to reduce, if not eliminate, the significant amount of stock fraud and manipulation that had contributed to the crash.[29] The Acts aimed to reinforce investor confidence in the market and gain a measure of control over the quality of investments being offered and traded.[30] The Securities Act chiefly targeted initial offerings of securities in the primary market,[31] while the Exchange Act focused on the subsequent buying and selling of securities in the secondary market.[32] Both Acts require issuers of securities to disclose their companies' finances, operations, competitors, equity currently issued, and any other information necessary for investors to make an informed decision about whether to trade in the security.[33] One of the general goals of Section 5 of the Securities Act,[34] and the Securities Act as a whole, is to ensure that parties have sufficient and accurate

28. *See supra* note 14.

29. *See* Thel, *supra* note 14, at 408-13 (describing other contributing factors in the stock market crash, including massive speculation, aggressive short-selling, and the actions of officers of major investment banks, who transacted in large blocks and purposely affected the price of stocks they personally held); *see also* Escoffery, *supra* note 14, at 1783-84 (stating that "manipula[tion] and deceptive trading practices... significantly contributed to the" 1928 crash). Short selling is the "sale of a security... not owned by the seller.... If the seller can buy that stock later at a lower price, a profit results; if the price rises, however, a loss results." John Downes & Jordan Elliot Goodman, Dictionary of Finance and Investment Terms 407 (3d ed. 1991).

30. Escoffery, *supra* note 14, at 1784.

31. Hazen, *supra* note 14, at 7. Primary markets are the "market[s] for new issues of securities," Downes & Goodman, *supra* note 29, at 335, such as initial public offerings.

32. *See* Hazen, *supra* note 14, at 8. Secondary markets are "exchanges and over-the-counter markets where securities are bought and sold subsequent to original issuance." Downes & Goodman, *supra* note 29, at 394. An over-the-counter market ("OTC market") is a "market in which securities transactions are conducted through a telephone and computer network connecting dealers in [securities], rather than on the floor of an exchange." *Id.* at 306. OTC markets, typically used by smaller companies, have become popular with technology firms that do not meet the requirements to be listed on a stock exchange.

33. *See, e.g.*, 15 U.S.C. § 77(aa) (1994) (detailing the information required in registration statements).

34. Section 5 of the Securities Act requires that all security offerings be registered with the SEC through a series of disclosure documents. *Id.* at § 77(e) (1994). Disclosure documents typically include detailed descriptions of the issuing entity and its finances, operations, personnel and goals as well as the security being issued. *See id.* at § 77(g) (1994); *id.* at § 77(aa) (1994). *See generally* Hazen, *supra* note 14, 163-66 (noting that there are certain exceptions to registration requirements, for example, Section 3 creates exempt securities, such as government bonds, while Section 4 creates exempt transactions, such as limited offerings to accredited investors).

information about securities on which to rely for their investment decisions.[35]

Section 10(b) is the general anti-fraud provision of the Exchange Act.[36] Under the auspices of Section 10(b),[37] the Securities and Exchange Commission promulgated Rule 10b-5,[38] which makes it illegal to defraud by any means or method, or to make material omissions or misstatements of material facts in connection with a securities transaction.[39]

Originally, only the federal government was entitled to bring an action under Rule 10b-5 because the rule did not expressly grant private parties the right to do so.[40] In 1946, however, federal court in the Eastern District of Pennsylvania first recognized private causes of action under Rule 10b-5 in *Kardon v. National Gypsum Co.*[41] The *Kardon* court based its decision primarily on the torts of deceit and misrepresentation under common law.[42] The court noted that while

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35. *See* Hazen, *supra* note 14, at 78.

36. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994). Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

37. *Id.* (providing "rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors").

38. 17 C.F.R. § 240.10b-5 (2000).

39. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

40. *See* Hazen, *supra* note 14, at 764.

41. 69 F. Supp. 512 (E.D. Pa. 1946).

42. The court held that when one violates a law which is intended to "'protect an interest'" of another it creates liability between the parties. *Id.* at 513 (quoting Restatement of Torts, Vol. 2, § 286 (1934)). The court relied on the legal maxim, "Ubi jus ibi remedium." *Id.* (quoting Texas & Pacific Ry. Co. v. Rigsby, 241 U.S. 33, 39-40 (1916)). That maxim translates to "[w]here there is a right, there is a remedy."

there is no express language in Section 10(b) of the Exchange Act granting private parties the power to file civil suits for securities fraud, "the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies."[43] More than two decades later, the Supreme Court resolved any questions regarding the legitimacy of private causes of action in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[44] by noting "[i]t is now established that a private right of action is implied under § 10(b)."[45]

While the *Kardon* court failed to provide specific guidance regarding the plaintiff's burden of proof, subsequent federal courts developed the necessary elements of common law fraud that are now applied to civil securities fraud suits under Rule 10b-5.[46] A plaintiff must show that the defendant (1) "in connection with the purchase or sale of any security"[47] (2) acted with scienter[48] (3) by misstating or failing to disclose (4) a material fact[49] (5) "upon which the plaintiff justifiably relied" (6) "that proximately caused [the] plaintiff's" injury.[50] In proving the element of reliance, courts require plaintiffs to establish that they directly relied on a material misrepresentation.[51] Historically, plaintiffs' only option was to prove that they had relied on disclosure materials, such as prospectuses and annual statements, by showing either a material misstatement in the materials or an omission of a material fact from disclosure statements, which caused the plaintiff's injury through either the purchase or sale of the security.[52] Proving actual reliance on the defendant's

Black's Law Dictionary 1695 (7th ed. 1999).

43. *Kardon*, 69 F. Supp. at 514. The court felt that because Congress did not clearly withhold the right to file private civil suits under Section 10(b), and because the right to recover for harm caused by the violation of a law is "so fundamental and so deeply ingrained," such a right exists. *Id.*

44. 404 U.S. 6 (1971) (deciding that the plaintiff, as an investor, was harmed financially because of the defendant's fraud in the sale of securities and entitled to a civil remedy under Section 10(b)).

45. *Id.* at 13 n.9.

46. *See, e.g.*, Gasner v. Bd. of Supervisors, 103 F.3d 351, 356 (4th Cir. 1996) (describing the plaintiff's burden of proof in a Rule 10b-5 cause of action).

47. 17 C.F.R. § 240.10b-5 (2000); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (holding that only parties who have bought or sold a security may pursue relief through a private cause of action under Rule 10b-5).

48. The Supreme Court established the requirement of scienter in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 201 (1976) (interpreting the language of Section 10(b) to imply that deceptive intent is necessary). Scienter is "[a] mental state consisting in an intent to deceive, manipulate, or defraud." Black's Law Dictionary 1347 (7th ed. 1999).

49. *See infra* note 61.

50. *Gasner*, 103 F.3d at 356 (describing the plaintiff's burden in Rule 10b-5 private actions).

51. *See id.* For a description of the other five requirements, see Escoffery, *supra* note 14, at 1786-93.

52. Reliance is a fact-specific inquiry, and courts generally look to the following factors, as enumerated in *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983):

(1) the sophistication and expertise of the plaintiff in financial and securities

misrepresentation was considered a necessary part of a plaintiff's claim because it is the "causal connection" that links the plaintiff's loss to the defendant's act or omission.[53] Reliance, or "transaction causation," requires the plaintiff to show that the defendant's misrepresentation caused the plaintiff to purchase or sell the security.[54]

Courts have allowed private plaintiffs to use various methods to establish both actual and presumed reliance. Courts presume reliance in situations where proving actual reliance would be too burdensome on the plaintiff or irrelevant to the specific cause of action.[55] Specifically, the Supreme Court has approved two presumptions of reliance, the *Affiliated Ute* Presumption[56] and the fraud-on-the-market theory.[57]

B. *Universally Accepted Presumptions of Reliance*

1. The *Affiliated Ute* Presumption

In the landmark case of *Affiliated Ute Citizens v. United States*, the Supreme Court presumed a private plaintiff's reliance on a defendant's misrepresentations rather than requiring proof of actual reliance. The *Affiliated Ute* Court found that the defendants violated Rule 10b-5(a) and (c) of the Exchange Act[58] because they failed to disclose material information to individuals for whom they traded

> matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the [securities] transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

Id. at 1516.

53. Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) (stating also that there are multiple methods to satisfy the plaintiff's burden of proof).

54. Hazen, *supra* note 14, at 816-17 & n.8. Reliance and proximate causation are closely related concepts and are therefore often misapplied. *See id.* Proximate cause, or loss causation, requires the plaintiff to show that the defendant's misrepresentation in fact caused the security to be improperly valued in the market, which in turn caused the plaintiff's actual financial harm. McGonigle v. Combs, 968 F.2d 810, 820-21 (9th Cir. 1992); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-31 (1975) (holding that the plaintiff, in order to bring a civil suit under Rule 10b-5, must have purchased or sold the security at issue); Huddleston v. Herman & MacLean, 640 F.2d 534, 549 n.24 (5th Cir. 1981) (describing different elements of causation in Rule 10b-5 actions). *See generally* Tower C. Snow, Jr., et al., *Defending Securities Class Action*, *in* ALI-ABA Course of Study 789, 819-21 (2000) (discussing the causation requirement).

55. *Infra* text accompanying note 69.

56. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); *see* discussion *infra* Part I.B.1.

57. *Basic Inc.*, 485 U.S. at 241-49; *see* discussion *infra* Part I.B.2.

58. 17 C.F.R. § 240.10b-5 (2000).

stock.[59] The Supreme Court held that "positive proof of reliance is not a prerequisite to recovery" in cases alleging a defendant's failure to disclose.[60] Instead, a plaintiff must only show that the non-disclosed information was material,[61] because a "reasonable investor" would rely on that information in his or her decision-making.[62] The tenor of the Court's opinion indicated that securities fraud cases brought under Rule 10b-5 require a certain amount of flexibility in proving reliance, as evidenced by the Court's statement that, "[w]e do not read Rule 10b-5 restrictively."[63]

2. *Basic Inc. v. Levinson*: The Fraud-on-the-Market Theory

The *Affiliated Ute* presumption of reliance grants plaintiffs a narrow presumption, applicable only in situations where defendants allegedly failed to disclose material information. Yet in *Blackie v. Barrack*,[64] the Ninth Circuit chose to expand the reliance doctrine beyond a defendant's material omission to include situations of affirmative material misrepresentation.

The *Blackie* court was the first to expressly remove the requirement that a plaintiff prove actual reliance on a defendant's affirmative and misrepresentative statements. In *Blackie*, the court stated that an investor "relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price."[65] By affirmatively misrepresenting the financial condition of their company, thereby causing the market to overvalue the stock price, the defendants had committed a fraud on the market as a whole.[66]

59. *See Affiliated Ute*, 406 U.S. at 152-54. Two of the defendants, Gale and Haslem, worked at the bank that was acting as the transfer agent for the sale of stock from mixed-blood members of the Ute tribe to non-native American buyers. *See id.* at 145-47. Gale and Haslem did not disclose to the sellers that they were receiving commissions and gratuities for each sale and that the market price of the stock was upwards of $200 per share higher in the non-native American market. *See id.* at 147, 153.

60. *Id.* at 153.

61. Materiality is a question of fact. *See Basic Inc.*, 485 U.S. at 239-40; Hazen, *supra* note 14, at 797. Federal courts have referred to the Restatement of Torts for a clear definition of materiality to be applied to Rule 10b-5 cases. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) (stating that the "basic test of 'materiality' . . . is whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question'" (alteration in original) (citation omitted)); *see also* Hazen, *supra* note 14, at 793-95.

62. *Affiliated Ute*, 406 U.S. at 153-54.

63. *Id.* at 152. This is consistent with one of the points the Supreme Court made just one year earlier in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). The Court in *Superintendent* stated that "Section 10(b) must be read flexibly, not technically and restrictively." *Id.* at 12.

64. 524 F.2d 891 (9th Cir. 1975).

65. *Id.* at 907.

66. *Id.* at 894, 902-08.

The Supreme Court upheld the lower court's new doctrine in *Basic Inc. v. Levinson*,[67] ruling that the plaintiffs' presumption of reliance based on the fraud-on-the-market theory was valid.[68] The Court held that "[r]equiring a plaintiff to show a speculative state of facts, i.e., how he would have acted . . . if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market"[69] and that "'the hiding and secreting of important information obstructs the operation of the markets as indices of real value.'"[70]

Under the fraud-on-the-market theory, instead of demonstrating actual reliance on information contained in a prospectus, a plaintiff satisfies the reliance requirement by showing that the market price of the security as a whole was affected by the defendant's misstatement or omission, and that the plaintiff suffered a loss due to a transaction at that incorrect price.[71] This theory presumes that there is an efficient secondary market[72] and that the market has incorporated the defendant's actions into the price of the security in question.[73]

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67. 485 U.S. 224 (1988). Plaintiffs, former Basic Inc. shareholders, claimed that Basic Inc.'s three denials of a potential merger were material misrepresentations. *Id.* at 227-28. The defendants, just months after the denials, announced the buy-out of its stock by another company. *Id.* Plaintiffs sold shares prior to the merger announcement at allegedly undervalued market price because of the market's reliance on the denials of the merger. *Id.* at 228. Generally, a merger announcement will cause an increase in the target company's stock price because the acquiring company pays higher than market value for the shares (called a premium). *See* Robert W. Hamilton, The Law of Corporations in a Nutshell 370 (4th ed. 1996); *see also* Lewis D. Solomon, et al., Corporations Law and Policy: Materials and Problems 1170-73 (4th ed. 1998). Plaintiffs alleged that if the defendants had either remained silent or confirmed the merger negotiations, Basic Inc.'s share price would have been higher when plaintiffs sold it. *Basic Inc.*, 485 U.S. at 228.

68. *Basic Inc.*, 485 U.S. at 250.

69. *Id.* at 245 (citations omitted).

70. *Id.* at 246 (quoting the Congressional record, see H.R. Rep. No. 1383, at 11 (1934), discussing the drafting of the Exchange Act).

71. *See id.* at 246-47.

72. *Supra* note 32 (defining secondary market); *see* Hazen, *supra* note 14, at 813; *see also* Marc I. Steinberg, Understanding Securities Law 196 (2d ed. 1996). The Sixth Circuit provided a general list of the elements of an efficient secondary market in *Freeman v. Laventhol & Horwath*, 915 F.2d 193 (6th Cir. 1990). They are as follows:

> (1) a large weekly trading volume; (2) the existence of a significant number of reports by securities analysts; (3) the existence of market makers and arbitragers in the security; (4) the eligibility of the company to file an S-3 Registration Statement; and (5) a history of immediate movement of the stock price caused by unexpected corporate events or financial releases.

Id. at 199. *See generally* Russell Robinson, Comment, *Fraud-on-the-Market Theory and Thinly-Traded Securities Under Rule 10b-5: How does a Court Decide if a Stock Market is Efficient?*, 25 Wake Forest L. Rev. 223, 247-51 (1990) (discussing the factors that comprise an efficient market). *But see generally* Victor L. Bernard et al., *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of Fraud-on-the-Market Theory*, 73 Neb. L. Rev. 781 (1994) (questioning the fraud-on-the-market theory based on empirical studies of efficient markets).

Plaintiffs, however, are not required to prove all of those factors conclusively in

While this theory eases the plaintiff's evidentiary burden, the defendant is not completely without defenses. The Supreme Court expressly created the fraud-on-the-market presumption of reliance to be rebuttable.[74] In *Basic Inc.*, the Court established a general standard for defendants to rebut the presumption by allowing "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) . . . or his decision to trade."[75] The defendant must show there was material information disclosed to the public with sufficient availability to counter-act or correct the misrepresentation.[76] The Court enumerated specific examples of how to rebut a plaintiff's reliance, such as a market maker's[77] knowledge of a potential merger, or if the news of the merger entered the market through alternate, but credible, sources.[78]

The fraud-on-the-market theory is especially useful for plaintiffs in class actions. It allows the class to certify even if there are different levels of reliance among its members because it creates a presumption of reliance for the entire class.[79] The Federal Rules of Civil Procedure require that all members of a class have a common question of law or fact that predominates over individual questions.[80] Without the fraud-on-the-market presumption of reliance, a group of plaintiffs consisting of some members who have read and relied on a disclosure statement,

order to establish that an efficient market exists. *See Freeman*, 915 F.2d at 199; Cammer v. Bloom, 711 F. Supp. 1264, 1287 (D.N.J. 1989) (stating that there is no clear test to determine "whether a stock trades in an 'open and efficient market'"); Steinberg, *supra*, at 196.

73. *See Basic Inc.*, 485 U.S. at 247.

74. *Id.* at 250; Blackie v. Barrack, 524 F.2d 891, 906 n.22 (9th Cir. 1975) (noting that the general view is that the presumption of reliance is a rebuttable one); Steinberg, *supra* note 72, at 197; *see also In re* Apple Computer Sec. Litig., 886 F.2d 1109, 1116 (9th Cir. 1989) (holding that misleading statements made by corporate insiders must be countered by sufficiently credible and public information to prevent Rule 10b-5 liability). There is an argument, however, that it is nearly impossible for a defendant to effectively rebut this presumption in class action cases, because when reliance is determined to exist as a matter of law for a class, there is no rebuttable element. *See Basic Inc.*, 485 U.S. at 256 n.7 (White, J., concurring in part and dissenting in part); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 399-400 (2d Cir. 1973) (Mansfield, J., concurring and dissenting) (arguing that the Supreme Court, by not remanding in two previous cases involving material misrepresentations, "established a rule of law rather than a 'presumption'").

75. *Basic Inc.*, 485 U.S. at 248.

76. *See Apple*, 886 F.2d at 1116.

77. A market maker is a broker-dealer who creates a market in a security. Making a market is to "maintain firm bid and offer prices in a given security by standing ready to buy or sell round lots at publicly quoted prices." Downes & Goodman, *supra* note 29, at 239 (emphasis omitted).

78. *Basic Inc.*, 485 U.S. at 248-49.

79. *See* Kirkpatrick v. J.C. Bradford & Co., 827 F.2d 718, 722-25 (11th Cir. 1987); Julie A. Herzog, *Fraud Created The Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 Geo. Wash. L. Rev. 359, 370 (1995). *See generally* Snow, *supra* note 54, at 931-36.

80. Fed. R. Civ. P. 23(b)(3).

and other members who have not, could not be certified as a class.[81] If the potential class as a whole is allowed to substitute a presumption of reliance for actual individual reliance, a significant procedural barrier is therefore removed. Under the fraud-on-the-market theory, it is irrelevant whether each plaintiff has read a company's disclosure statements, because the manipulated stock price itself is the fraud.

Although the fraud-on-the-market theory acts to remedy a defendant's wrongdoings in an efficient secondary market, plaintiffs lacked a similar tool to combat fraud in the primary market.[82] As a result, a number of courts have extended the presumption of reliance to newly-issued securities in the primary market through the fraud-created-the-market theory.

C. Shores v. Sklar: *The Fraud-Created-the-Market Theory of Reliance*

Under the fraud-created-the-market theory, a plaintiff relies on the market itself to prevent unmarketable securities from even being issued. In order for a security to be issued, a company must first disclose to the public material information regarding both the issuing company, and the security being issued.[83] Such disclosure provides potential purchasers with the appropriate information to make their investment decisions.[84] Because the SEC does not perform due diligence to ensure that the disclosures are accurate,[85] companies might intentionally misrepresent their financial strength, thus causing invalid securities to be issued into the market. Ultimately, if the SEC cannot prevent fraudulent securities from being issued, purchasers may only recoup losses from such fraudulent schemes through private causes of action[86] under Rule 10b-5.

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81. *See Basic Inc.*, 485 U.S. at 242.

82. *See* Joseph v. Wiles, 223 F.3d 1155, 1163 n.2 (10th Cir. 2000); Ross v. Bank South, N.A., 885 F.2d 723, 728 n.8 (11th Cir. 1989); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1121 (5th Cir. 1988). As noted in *Basic Inc.*, active secondary markets, by incorporating material and relevant information into a securities price, provide investors with a basis for reliance on that price. *See supra* notes 72-73 and accompanying text. In primary markets, the investor relies on the issuing parties for pricing accuracy based on the financial strength of the issue. The focus of the fraud-created-the-market theory, as discussed below, is not that the issuer mispriced the security, but that the security should not have been issued at all. *See infra* Part I.C. The fraud-created-the-market theory has been applied to the primary market, and may potentially apply to inefficient secondary markets. Lipton v. Documation, Inc., 734 F.2d 740, 746 n.8 (11th Cir. 1984); *cf.* Shores v. Sklar, 647 F.2d 462, 467 (5th Cir. 1981) (en banc) (noting that while the district court held that the securities in question were purchased in the primary market, the circuit court stated that it was not so clear from the record, and that the bonds may have been trading in a secondary market).

83. Solomon et al., *supra* note 67, at 280-81; *see supra* notes 33-34 and accompanying text.

84. *See supra* notes 33-34 and accompany text.

85. *Infra* note 138.

86. *See* Solomon et al, *supra* note 67, at 281.

Rule 10b-5 has three distinct provisions prohibiting fraudulent devices or schemes, material misrepresentations and omissions, and operating fraudulent practices.[87] The court in *Shores v. Sklar*[88] stated that in claims arising under Rule 10b-5(b), which include a "statement" by the defendant, plaintiffs are not allowed to presume reliance.[89] Only causes of action alleging violations of Rule 10b-5(a) and (c) are eligible to receive a presumption of reliance.[90] The court relied on the general language of Rule 10b-5(a) and (c) in holding that plaintiffs need not read and rely on disclosure documents.[91] In contrast, Rule 10b-5(b) requires a plaintiff to have read and relied on a defendant's fraudulent statements because the specific language of Rule 10b-5(b) requires an "untrue statement" by the defendant.[92]

The central focus of the fraud-created-the-market theory is the concept of unmarketability. If a security should not have been issued and could not have been issued, if not for the intentional fraud of a party, it is unmarketable, because the security is essentially worthless.[93] Plaintiffs are granted a presumption of reliance by the court because actual reliance on sham disclosure materials is irrelevant. The plaintiff has not relied on disclosure documents to ascertain whether in fact the security is a sham because the very presence of the security and its accompanying disclosure materials indicates that the security is bona fide.[94] As a result, investors rely on such materials to ascertain the fair market value of a security, while relying on the presence of a security in the market as an indication that it is not a sham.[95]

Accordingly, in *Shores*, the Fifth Circuit held that a plaintiff could avoid proving actual reliance if he or she could show that:

> (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) [plaintiff] reasonably relied on the [securities'] availability on the market as an indication of their apparent

87. For the complete text of Rule 10b-5, see *supra* note 39. The current version of Rule 10b-5 uses (a), (b) and (c) to denote its subsections, while the older version of Rule 10b-5 that was in force at the time of *Shores* used (1), (2) and (3) respectively.

88. 647 F.2d 462 (5th Cir. 1981) (en banc).

89. *Id.* at 468-69.

90. *Id.* at 469-70. Under both Rule 10b-5(a) and (c), "causation in fact ... [is] proved [if] the scheme was intended to and did bring the [b]onds onto the market fraudulently" and the plaintiffs proved reliance "on the integrity of the offerings of the securities market." *Id.* at 469. In comparison, Rule 10b-5(b) states that it is illegal "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b) (2000).

91. *Shores*, 647 F.2d at 469.

92. 17 C.F.R. § 240.10b-5(b); *Shores*, 647 F.2d at 468-69.

93. *See Shores*, 647 F.2d at 470-71.

94. *See id.*

95. *See id.*

> genuineness, and (3) as a result of the scheme to defraud, [plaintiff] suffered a loss.[96]

This case of first impression in the Fifth Circuit set forth the fraud-created-the-market theory. The plaintiffs were purchasers of municipal revenue bonds,[97] which dropped sharply in value shortly after their purchase.[98] This price decrease was caused by the default of the bond's underlying income source in paying the rent supporting the bonds.[99] The plaintiffs alleged, among other things, that the issuers of the bond were perpetrating a fraud on investors by misrepresenting the ability of the underlying project to produce the revenue needed to pay off the bonds.[100] The fraud-created-the-market theory applied because the plaintiffs were not recovering under a claim that they had purchased intentionally mispriced bonds, but rather that they had purchased bonds that should not have been issued or sold in the first place.[101] The lower court granted summary judgment to the defendants based on the plaintiffs' admission that they failed to read the offering circular[102] prior to purchasing the bonds.[103] The Fifth Circuit, however, sitting en banc with ten judges dissenting, vacated the district court's holding[104] and held that the plaintiffs need only establish reliance on the security's market availability to meet the reliability requirement in a fraud cause of

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96. *Id.* at 469-70 (citations omitted).

97. Municipal revenue bonds are "bond[s] issued to finance public works . . . and supported directly by the revenues of the project . . . . Unless otherwise specified . . . holders of these bonds have no claim on the issuer's other resources." Downes & Goodman, *supra* note 29, at 266. The bonds in the present case were a specific type of municipal revenue bond called Industrial Development Bonds, which are "issued to finance fixed assets that are then leased to private firms, whose payments [pay down] the debt." *Id.* at 199 (emphasis omitted). In *Shores*, the revenue bonds were bonds of the Industrial Development Board of Frisco City, Alabama. 647 F.2d at 465. They were issued under Alabama state law that provided for the incorporation of an Industrial Development Board ("Board") by cities to secure financing for the construction of industrial facilities. *Id.* The municipality leases the facility to a company looking to operate industrial sites in Alabama. *Id.* These bonds were secured by the revenue of the lease of the industrial facility, and liability was limited to the Board, not the city. *Id.*

98. *Shores*, 647 F.2d at 463-64. The court noted that it was unclear whether the bonds were purchased in the primary or secondary markets, despite the district court's holding that they were purchased in the primary market. *Id.* at 467.

99. *See id.* at 463-64.

100. *Id.* at 466-67 (noting, as examples, that the defendants claimed they had prior success in this field, that there was a multi-million dollar property owned by the defendants to build the project on, and that they overstated the value of assets on the company's balance sheet included in the offering documents).

101. *See id.* at 470-71.

102. An offering circular, or prospectus, is a "formal written offer to sell securities that sets forth the plan for a proposed business enterprise." Downes & Goodman, *supra* note 29, at 289, 341; *see also supra* note 32.

103. *Shores*, 647 F.2d at 464.

104. *Id.* at 464, 472.

action.[105] The court stated that the legislative intent of the Exchange Act was to create a broad source of protection against securities fraud and to promote general standards of "honesty and fair dealing."[106] The court established a standard for certain securities to receive this form of reliance presumption because without the intentional fraud the securities could not have been issued.[107] The presumption of reliance was to be allowed for securities "not entitled to be marketed."[108]

The dissent in *Shores* questioned the majority's interpretation of the original intent of the Exchange Act, arguing that the purpose of that Act was to create informed investors, not to guarantee a security's value simply because it is in the market.[109] The dissent also voiced the concern that this particular presumption of reliance would open the floodgates to federal causes of action and further prolong frivolous litigation that would have otherwise been resolved at summary judgment.[110]

Since *Shores*, courts have significantly refined the exact definition of an "unmarketable" security, most notably regarding the creation of two classifications of unmarketability, economic and legal.[111] Economic unmarketability focuses on whether a security has any underlying financial value, specifically, whether the underlying company exists and has any assets.[112] Legal unmarketability, on the other hand, focuses on whether the entity issuing the security complied with regulatory procedures required to issue that type of security.[113] Under the legal unmarketability standard, a company may have assets, but has failed to comply with one or all of the legal requirements. Both economic and legal unmarketability require fraudulent intention on the part of the issuer.[114] The circuits that subsequently have applied the fraud-created-the-market theory's presumption of reliance have clarified their individual interpretations of the proper application of it, while the courts that follow the dissent's reasoning in *Shores* have accordingly rejected the theory.

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105. *Id.* at 469-70.

106. *Id.* at 470 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976)); *infra* Part III.B.1 (discussing the legislative intent of the Exchange Act). The Supreme Court in *Ernst* referred directly to a House of Representatives Report in describing the intent and design of the Exchange Act. *Ernst*, 425 U.S. at 195 (referencing H.R. Rep. No. 792-73, at 1-5 (1934)).

107. *See Shores*, 647 F.2d at 469-70.

108. *Id.* at 469.

109. *Id.* at 473 (Randall, J., dissenting); *see also* Herzog, *supra* note 79, at 396-403 (discussing how the fraud-created-the-market theory undermines the intent of federal securities law).

110. *Shores*, 647 F.2d at 473 (Randall, J., dissenting).

111. *See, e.g.*, Joseph v. Wiles, 223 F.3d 1155, 1163-64, 1166 (10th Cir. 2000) (describing the different types of unmarketable securities).

112. *Id.* at 1164.

113. *Id.*

114. *Supra* note 48.

II. THE CIRCUITS' DISAGEEMENT OVER THE PROPER APPLICATION OF THE FRAUD-CREATED-THE-MARKET THEORY

While some federal courts since *Shores* have continued to apply the fraud-created-the-market theory, they have differed on its exact application. Specifically, the circuits have diverged on the degree of flexibility that is required when courts are determining what amount of underlying assets in a company prevents that company's securities from being economically unmarketable or "patently worthless". The Third, Sixth and Eleventh Circuits established that their standard for "patently worthless" requires that there be no assets in the company underlying the security in question, while the Fifth Circuit allows for a certain degree of flexibility in the amount of assets. The Fifth Circuit focuses more on the intention of the issuer rather than an absolute dollar amount. The Sixth and Seventh Circuits have apparently rejected the fraud-created-the-market theory, in part because of their possible misinterpretation of *Shores* and in part because of insufficient facts in the cases before them that were needed to properly apply the theory.

A. *Circuit Courts Adopting the Fraud-Created-the-Market Theory*

Subsequent to *Shores*, the Third, Tenth, and Eleventh Circuits adopted versions of the Fifth Circuit's fraud-created-the-market theory, while the Fifth Circuit continues to tie its version to whether a security is "worthless."[115] None of the circuits, however, has wholeheartedly embraced the doctrine, but rather they apply it in narrow circumstances. The Ninth Circuit's presumption of reliance theory, established prior to *Shores*, significantly differs from the other circuits' fraud-created-the-market doctrines, and is thus labeled "reliance on the regulatory body."[116]

1. The Fifth Circuit

Six years after *Shores*, the Fifth Circuit took the first small step towards clarifying its requirements for unmarketability under the fraud-created-the-market theory in *Finkel v. Docutel/Olivetti Corp.*[117] In *Finkel*, the court reiterated that plaintiffs can be relieved of the burden of proving direct reliance on a defendant's misrepresentation.[118] The court stated that private plaintiffs could instead show that the issuers "conspired to bring to market securities

115. Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988).
116. *Infra* Part II.A.5.
117. 817 F.2d 356 (5th Cir. 1987). The plaintiff alleged that the defendant, through the use of over-inflated inventory valuations and an intentional delay in reporting losses caused by the over-inflation, intentionally manipulated the stock's market value. *Id.* at 357-58.
118. *See id.* at 361.

that were not entitled to be marketed."[119] It further held that the majority in *Shores* intended to allow the use of the *Basic Inc.* presumption of reliance[120] in situations involving the "issuance of worthless securities."[121] The *Finkel* court ultimately decided the issue under the fraud-on-the-market theory, rather than the fraud-created-the-market theory, because the security in question had some worth and in fact, was actively traded in an over-the-counter market.[122] The *Finkel* court clarified that *Shores* applied the fraud-on-the-market theory to "newly issued securities."[123] In *Finkel*, because of the crucial fact that the securities traded on a secondary market, the plaintiff could claim a presumption of reliance under the fraud-on-the-market theory.[124] This active secondary market allowed the plaintiff to allege that the defendant's fraudulent actions merely inflated the price, rather than caused an unmarketable security to enter the market.[125]

The Fifth Circuit further clarified its definition of unmarketable securities in the fraud-created-the-market theory context the following year in *Abell v. Potomac Insurance Co.*[126] While the defendants in *Abell* stated that a "worthless" security meant that investors did not recoup any of their investment, plaintiffs claimed a security was worthless if the issuers intended to operate a sham corporation.[127] The court agreed with the plaintiffs, stating "that securities meet the test of 'not entitled to be marketed' only where the promoters knew the enterprise itself was patently worthless," and here the defendants had no plans to operate an actual business.[128] The

119. *Id.* at 362.
120. *Supra* Part I.B.2.
121. *Finkel*, 817 F.2d at 364.
122. *Id.* at 364-65.
123. *Id.* at 364.
124. *Id.*
125. *Id.*
126. 858 F.2d 1104 (5th Cir. 1988). The plaintiff class claimed that the defendants fraudulently issued municipal revenue bonds to finance construction of a facility for the disabled. *See id.* at 1109, 1111-12. Most importantly, the plaintiffs argued that the defendants claimed that one party had pledged two million dollars to support the project, and that they omitted the complete details of a multi-million dollar real estate deal involving parties at the heart of the project. *Id.* at 1111-12.

The Supreme Court granted certiorari for *Abell* in 1989, vacating the judgment and remanding in light of *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229 (1989), which concerned racketeering standards under RICO. The Court remanded the cases on this issue only. Fryar v. Abell, 492 U.S. 914 (1989); Abell v. Potomac Ins. Co., 946 F.2d 1160, 1164 (5th Cir. 1991). The Supreme Court did not comment on any other aspect of the *Abell* decision.

127. *See Abell*, 858 F.2d at 1121-22. The plaintiffs based their definition of "worthless" on the defendant's intent and not the assets underlying the company because in *Shores*, the plaintiffs had received a portion of their initial investment through the bankruptcy proceedings. *Id.*; *Shores v. Sklar*, 647 F.2d 462, 464 n.1 (5th Cir. 1981).
128. *Abell*, 858 F.2d at 1122. The term "patently worthless," introduced by the *Abell* court, was subsequently labeled by other courts as "economic unmarketability." *See, e.g.*, Ockerman v. May Zima & Co., 27 F.3d 1151, 1160 (6th Cir. 1994).

Abell court's definition of "patently worthless" allowed for a certain degree of flexibility regarding the existence of actual assets in the underlying business.[129] The court found that the bonds in question were not traded on an active market,[130] which prevented them from the fraud-on-the-market presumption of reliance. Additionally, the securities were not completely worthless or issued only because of the fraud, because the bonds had some "legitimate value in the bond market," which prevented the plaintiffs from asserting the fraud-created-the-market theory.[131] Thus, the plaintiffs' claims were denied.[132]

The Fifth Circuit continues to interpret the fraud-created-the-market theory consistently with *Abell.*

2. The Tenth Circuit

The Tenth Circuit was the first to follow the Fifth Circuit's holding in *Shores* in *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*.[133] The court upheld the fraud-created-the-market theory, stating that "[w]e find the Fifth Circuit's reasoning in *Shores v. Sklar* to be persuasive."[134] It ruled that plaintiffs' reliance on the bond's presence in the market satisfied the elements of reliance on the defendant's misrepresentation.[135] The district court had found that the Irrigation Fuel Authority was not a properly formed public trust because it had failed to comply with numerous requirements of state law regarding public trusts.[136] The Tenth Circuit thus stated that

129. *Abell*, 858 F.2d at 1122 (noting that in *Shores* there were actual capital assets, but that did not prevent the court from declaring the bonds to be unmarketable).

130. *Id.* at 1121. As opposed to its decision in *Finkel*, the court in *Abell* noted that the facts before it were significantly similar to those in *Shores*, most importantly that the bonds were not trading on an efficient secondary market. *Id.*

131. *Id.* at 1122-23.

132. *Id.* at 1123.

133. 717 F.2d 1330 (10th Cir. 1983). The plaintiff was a securities broker-dealer, attempting to lead a class action suit against the defendant. *Id.* at 1331-32. The plaintiff alleged that the bonds issued by the defendants were, in fact, illegally issued under Oklahoma law. *Id.* at 1331. The plaintiff alleged that the offering circular was misleading and that the bond opinion was issued "recklessly" by the bond counsel. *Id.* at 1331-32. The defendants were also accused of improperly using the funds, and even more seriously, that they had no initial intention to use the funds raised by the offering for the activity described in the offering circular. *See id.* The bonds in question, similar to those in *Shores*, were created to provide financing for the establishment of an industrial facility. *Id.* at 1331. Also, as in *Shores*, the bonds in *T.J. Raney* defaulted. *Id.* at 1332. The defendants sought to decertify the plaintiffs' class because only a portion of the class members read the disclosure documents. *Id.*

134. *Id.* at 1333.

135. *Id.*

136. *In re* Fort Cobb, Okla., Irr. Fuel Auth., 468 F. Supp. 338, 343 (W.D. Okla. 1979). The court ruled that the Authority had failed to establish "an authorized or proper function of the beneficiary," providing benefits to non-beneficiaries, and that the trust had been improperly accepted. *Id.* at 342-43.

the defendants were therefore not legally able to market securities under Oklahoma law.[137]

The court, however, was cautious in following *Shores*, noting that the earlier decision did not intend to "'establish a scheme of investors' insurance,'"[138] which would guarantee a cause of action for any investor in any security. Rather, *T.J. Raney* limited the scope of the *Shores* holding to new securities illegally issued.[139] The court established the "legally unmarketable" category of the fraud-created-the-market theory, which applies to cases in which a defendant had no legal authority to issue the securities because he or she bypassed procedural requirements necessary to issue valid securities.[140] *T.J. Raney* focused on investors' ability to rely on the market to provide the minimum assurance that securities are "qualified legally to be issued," meaning that investors may assume that an issuer complied with a regulatory or legislative body's procedures in bringing a security to market, such as creating the appropriate corporate form or public trust.[141] While other cases have discussed the validity of legal unmarketability, no other circuit has accepted it.[142]

The district courts in this circuit continued to refine the fraud-created-the-market theory.[143] In *Alter v. DBLKM, Inc.*, the District

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137. *T.J. Raney*, 717 F.2d at 1333 (relying on In re *Fort Cobb*, 468 F. Supp. at 343; *see also* Okla. Stat. Ann. tit. 60, § 176 (1994).

138. *T.J. Raney*, 717 F.2d at 1333 (quoting List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965)); *see* Shores v. Sklar, 647 F.2d 462, 469 n.5 (5th Cir. 1981) (en banc). The court in *T.J. Raney* also reaffirmed that no regulatory body (e.g. the SEC) reviews the value of a security prior to its issuance or ascertains the truthfulness of statements made in an offering document. *T.J. Raney*, 717 F.2d at 1333. The SEC requires that all offering documents disclose that the SEC "has [not] approved or disapproved of the disclosures in the securities or passed upon the accuracy or adequacy of the prospectus and that any contrary representation is a criminal offense." 17 C.F.R. § 229.501(b)(7) (2000).

139. *See T.J. Raney*, 717 F.2d at 1333. Other circuits have termed "illegally issued securities" as "legally unmarketable." *See, e.g.*, Ockerman v. May Zima & Co., 27 F.3d 1151, 1160 (6th Cir. 1994). This is distinct from "economic unmarketability." *Id.*

140. *Ockerman*, 27 F.3d at 1160.

141. *T.J. Raney*, 717 F.2d at 1333.

142. *See, e.g.*, *Ockerman*, 27 F.3d at 1160-61 & n.8. Some have commented that legal unmarketability as adopted by the Tenth Circuit is too closely related to the Ninth Circuit's highly criticized presumption of reliance on the regulatory process to be a valid theory of presumption. *See infra* Part II.A.5; Herzog, *supra* note 79, at 381-82.

143. *See* Rosenthal v. Dean Witter Reynolds, Inc., 945 F. Supp. 1412 (D. Colo. 1996). The plaintiffs alleged that the defendants made material misrepresentations, including those regarding various financial forecasts and economic difficulties the project was facing. *Id.* at 1418. The court found that the plaintiffs could not be granted a presumption of reliance because they failed to properly claim that the securities "'could not have been marketed at any price,'" which is required for the fraud-created-the-market theory. *Id.* (quoting plaintiff's brief). Additionally, in *Arena Land & Investment Co. v. Petty*, 906 F. Supp. 1470 (D. Utah 1994), *aff'd*, 69 F.3d 547 (10th Cir. 1995), the district court ruled that the plaintiffs could not make use of the fraud-created-the-market theory because their pleadings fell short of the required particularity. *Id.* at 1480-82.

Court of Colorado found that the plaintiff's case failed to meet the requirements of the fraud-created-the-market theory.[144] The court reiterated that because of government regulations controlling the securities issuance process, investors should be allowed at least a bare presumption of reliance that the securities were issued legally and in this case, while the defendants had made misrepresentations, their statements did not affect the legal authority of the issuer to sell the bonds.[145] While it followed the circuit's approach of legal unmarketability as established in *T.J. Raney*, the district court did implicitly indicate a willingness to consider economic unmarketability as a viable method.[146]

Recently, the Tenth Circuit expanded the scope of the fraud-created-the-market theory from a simple legal unmarketability requirement.[147] In *Joseph v. Wiles*, the Tenth Circuit upheld the district court's denial of the plaintiff's claim because the plaintiff failed to meet the standard of unmarketability for the fraud-created-the-market theory.[148] The court performed a detailed analysis of whether the plaintiff had satisfied the requirements of either economic or legal unmarketability, clarifying that "[t]here is a significant difference between securities which should not be marketed because they involve fraud," meaning economic unmarketability, "and securities which cannot be marketed because the issuers lack legal authority to offer them," or legal unmarketability.[149] The court found that while the defendant perpetrated a fraud by misrepresenting the finances of a distressed entity, the company was not worthless and thus not economically

144. 840 F. Supp. 799 (D. Colo. 1993). The Colorado Springs-Stetson Hills Public Building Authority issued bonds in 1986 and 1988 to finance the further development and improvement of a subdivision in Colorado Springs. *Id.* at 803. Less than one year after the plaintiffs purchased the bonds, the bond trustee announced a technical default. *Id.* Plaintiffs alleged that the defendants' fraud caused their investment decision. *Id.* The complaint generally claimed that the defendants misrepresented information regarding the financial condition of the project underlying the bonds, failed to disclose that there were violations of bond covenants, and ignored the project's trustees' concerns. *Id.* at 803-04.

145. *Id.* at 805 (citing *T.J. Raney*, 717 F.2d at 1333).

146. *Id.* at 805-06 (discussing fraud that is "so egregious" that there would be no market for the security).

147. Joseph v. Wiles, 223 F.3d 1155 (10th Cir. 2000). MiniScribe Corporation, a disk drive producer, publicly issued almost one hundred million dollars of convertible debentures in 1987. *Id.* at 1157. A debenture is a "general debt obligation backed only by the integrity of the borrower." Downes & Goodman, *supra* note 29, at 99. A convertible security is "exchangeable for a set number of another form [of securities] (usually common shares) at a pre-stated price." *Id.* at 86. In March of 1989, MiniScribe disclosed that its financial statements were unreliable. *Joseph*, 223 F.3d at 1157. Six months later, "widespread intentional fraud" was revealed, which had caused a significant over-inflation of the company's financial success. *Id.* Finally in 1990, MiniScribe filed for bankruptcy. *Id.*

148. *Joseph*, 223 F.3d at 1164-65.

149. *Id.* at 1165.

unmarketable.[150] It noted that the bonds did not meet either of the two interpretations of economic unmarketability being applied in the federal courts.[151] The court first applied the rigid view of "patently worthless," which requires that the securities have absolutely no underlying assets.[152] Because the plaintiff received $8,147 for his securities,[153] he was unable to claim that the bonds in question were "patently worthless" as defined by the strict standard.[154] Next, the court attempted to apply the *Abell* court's more flexible view of "patently worthless," allowing for a minimal amount of assets supporting the entity.[155] The plaintiff failed to meet this requirement as well.[156] While the court analyzed the applicability of both definitions of economic unmarketability, however, it did not establish a clear standard.

Further, the plaintiff in *Joseph* did not allege that "the debentures were issued without lawful authority," so the court stated that it could not grant a presumption of reliance based upon legal unmarketability.[157] The court noted that for a security to meet the legal unmarketability standard it must be issued by an entity that has not been granted the legal authority to do so from the appropriate governmental body and thus does not have the power to issue the securities. The plaintiffs, however, failed to allege a claim based upon legal unmarketability.[158]

Joseph upheld legal unmarketability as defined previously in *T.J. Raney*[159] and discussed economic unmarketability without deciding on the proper definition.[160] The court stated that it could not presume reliance for the plaintiff "[b]ecause he has not alleged that his debentures were economically or legally unmarketable."[161] While the securities were overvalued because of the defendant's misrepresentations in the financial statements, they were, in fact,

150. *Id.* at 1164.

151. *Id.* at 1164 & n.3.

152. *Id.* at 1164. The Sixth Circuit in *Ockerman v. May Zima & Co.*, 27 F.3d 1151 (6th Cir. 1994), the Eleventh Circuit in *Ross v. Bank South, N.A.*, 885 F.2d 723 (11th Cir. 1989), and the Eastern District of Pennsylvania in *In re Bexar County Health Facility Development Corp. Securities Litigation*, 130 F.R.D. 602 (E.D. Pa. 1990) were the main proponents of this interpretation of "patently worthless." For further discussion, see *infra* Parts II.B.1, II.A.3 and II.A.4, respectively.

153. The plaintiff lost approximately $17,000 on his investment. *Joseph*, 223 F.3d at 1157, 1164.

154. *Id.* at 1164.

155. *Id.* (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988); *see supra* notes 128-29 and accompanying text.

156. *Joseph*, 223 F.3d at 1164.

157. *Id.* at 1164-65.

158. *Id.*

159. *Id.* at 1165; *see* T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irr. Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983).

160. *Joseph*, 223 F.3d at 1164-65.

161. *Id.* at 1165.

marketable. The language of *Joseph*, as noted above, signals the Tenth Circuit's possible willingness to broaden the fraud-created-the-market theory from solely legally unmarketable securities to situations involving economic unmarketability.[162]

3. The Eleventh Circuit

While the Eleventh Circuit[163] first discussed the validity of the fraud-created-the-market theory in dicta in 1984 and 1987,[164] it did not directly decide upon its legitimacy until 1989, in *Ross v. Bank South, N.A.*[165] In *Ross*, the court held that the fraud-created-the-market theory was meant to require plaintiffs to satisfy a "high threshold,"[166] because it only applies to "securities that are so tainted by fraud as to be totally unmarketable."[167] The plaintiffs failed to meet what the court saw as *Shores*' narrow requirements for presuming reliance

162. *Id.*

163. The United States Court of Appeals for the Eleventh Circuit was created out of the Fifth Circuit by the Fifth Circuit Court of Appeals Reorganization Act of 1980, Pub. L. No. 96-452, 94 Stat. 1995 (1981). *See* Bonner v. City of Prichard, 661 F.2d 1206, 1207, 1209 (11th Cir. 1981) (en banc) (holding that as of September 30, 1981, Fifth Circuit decisions, such as *Shores*, are binding precedent in the Eleventh Circuit).

164. The first case was *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984). The plaintiffs in *Lipton* claimed that the defendants had publicly released information intentionally misrepresenting income when in fact the company had suffered a net loss. *Id.* at 741. The circuit court affirmed the lower court's denial of the defendant's motion to dismiss. *Id.* at 748. The court noted and agreed with the Fifth Circuit's decision in *Shores* that the presumption of reliance should be narrowly applied to securities that would have been unmarketable if not for the fraud in situations involving newly-issued securities. *See id.* at 746-47. The *Lipton* court was more concerned with the general theory of fraud-on-the-market that it found implicit in *Shores*, because this case was decided prior to the Supreme Court's ruling in *Basic Inc.*, and additionally, this was a situation involving newly-issued securities. *Id.* at 747.

Three years later, in *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718 (11th Cir. 1987), the court focused on applying the holding in *Shores* to the specific question of class certification under Federal Rule of Civil Procedure 23(b)(3). *Id.* at 721-23. Plaintiffs claimed that defendants made misrepresentations in the prospectus about the company's distressed economic condition. *Id.* at 720. The defendants claimed that there were "individual questions of reliance on the part of the particular purchasers." *Id.* at 721. The court held that a presumption of reliance was ideally applicable to class action cases because all investors relied on the market. *Id.* at 723; *see supra* text accompanying notes 79-81. The presumption of reliance eliminates the problem that some members of a class may have relied on certain misrepresentations while other members did not. *Kirkpatrick*, 827 F.2d at 723; *see supra* text accompanying notes 79-81.

165. 885 F.2d 723 (11th Cir. 1989) (en banc). The plaintiff in this case purchased First Mortgage Residential Facilities Revenue Bonds ("Revenue Bonds") issued by the Special Care Facilities Financing Authority of the City of Vestavia Hills. *Id.* at 725. The Revenue Bonds were sold to finance the building of a facility for the elderly in Alabama. *Id.* at 725-26. According to the issuing documents, the repayments of the Revenue Bonds were absolutely dependent on the sales of residential units in the facility. *Id.* at 727. There were insufficient sales and the Revenue Bonds defaulted after the project filed for bankruptcy. *Id.*

166. *Id.* at 732.

167. *Id.* at 729.

because the securities were not unmarketable.[168] The Eleventh Circuit viewed *Shores* as establishing that the plaintiff must prove that the defendants intended to publicly issue securities that otherwise could not be issued.[169] The court used as its benchmark an even stricter measure of economic unmarketability than the Fifth Circuit did in *Abell* to determine if it would allow a presumption of reliance.[170] It stated that the "fraud must be so pervasive that it goes to the very existence of the bonds."[171] The plaintiffs in *Ross* did not sufficiently establish that the defendants' fraud rendered the revenue bonds in question unmarketable at the original price,[172] or even at any price.[173]

Ross' narrow interpretation of *Shores* typifies the federal circuits' disagreement over the appropriate application and validity of the theory.[174] The majority in *Ross* warned against a broad application of the fraud-created-the-market theory, noting that "plaintiffs must overcome what the *Shores* court intended to be a high threshold."[175] One of the concurring opinions in *Ross*, while agreeing with the case's result, stated that the court should expressly reject the fraud-created-the-market theory because the doctrine is "fundamentally flawed and should be overruled."[176] Conversely, two of the dissenting opinions affirmed the validity of the theory because they found *Shores* to persuasively argue that the fraud-created-the-market theory is a valid method of shielding investors from fraudulent securities and

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168. *Id.* at 729-30; *supra* text accompanying note 96.

169. *Ross*, 885 F.2d at 729-30 (quoting Shores v. Sklar, 647 F.2d 462, 469-70 (5th Cir. 1981) (en banc)).

170. *Id.* at 729.

171. *Id.*

172. *Id.* at 731 n.16. It is interesting that the court did not use the reasoning later employed by the Sixth Circuit in *Ockerman v. May Zima & Co.*, 27 F.3d 1151 (6th Cir. 1994). *See infra* Part II.B.1. In the present case, as in *Ockerman*, the investors received some return of their original investment through the bankruptcy proceedings. *See Ockerman*, 27 F.3d at 1153; *Ross*, 885 F.2d at 727 & n.5. The *Ockerman* court rejected the possibility that the securities in that case were economically unmarketable, based in part on the fact that the securities had some minimal value because the project, after filing for bankruptcy, was sold for a significant loss and investors recouped a small portion of their investment. *See Ockerman*, 27 F.3d at 1153, 1160; *see also In re* Bexar County Health Facility Dev. Corp. Sec. Litig., 130 F.R.D. 602, 611 (E.D. Pa. 1990) (reasoning that the plaintiffs were scheduled to receive at least a partial return on investment through the bankruptcy plan).

173. *Ross*, 885 F.2d at 731 n.16.

174. This was a cautious opinion, with two concurring opinions representing four judges and four separate dissenting opinions. *Id.* at 723.

175. *Ross*, 885 F.2d at 732.

176. *Id.* at 733, 739-44 (Tjoflat, J., specially concurring) (disagreeing with the majority on the issue of fraud-created-the-market, stating that while the plaintiffs had met the burden of proof required by *Shores*, it should be overruled).

furthering the Exchange Act's purpose of "free and honest securities markets."[177]

In 1988, the Eleventh Circuit, in *Shores v. Sklar* ("*Shores II*"), re-examined the validity of the fraud-created-the-market theory with regard to its particular application to class action cases brought under Rule 10b-5.[178] The court affirmed its holding in *Kirkpatrick* that the fraud-created-the-market theory is particularly appropriate in class actions, stating that "the distinction between purchasers relying on the circular and purchasers not so relying was immaterial."[179]

4. The Third Circuit

The District Court of Eastern Pennsylvania recognized the potential validity of the fraud-created-the-market theory in three cases it decided within a three-year period. Beginning in 1989, the court held in *Stinson v. Van Valley Development Corp.*[180] that the plaintiffs could not allege a presumption of reliance because the securities were not patently worthless.[181] While the court did not expressly accept the fraud-created-the-market theory, its language implied a general acceptance of the theory if the securities in question were patently worthless.[182] In discussing the plaintiffs' claim of a presumption of reliance based on the fraud-created-the-market theory, the court expressly stated that the theory was not applicable to the case before it, but it also did not reject the theory.[183] The court did state that the case at hand was not "the kind of sham or hoax warranting application of the fraud-created-the-market

177. *Id.* at 747-49 (Clark, J., dissenting) (disagreeing with the majority only on a single aspect of its decision, specifically that the defendants had no reason to think that their securities were probably heading for default, and agreeing with the underlying rationale of the *Shores* decision); *id.* at 746-47 (Johnson, J., dissenting) (agreeing with the presumption of reliance created by *Shores*, but stating that the present facts did not allow for the grant of summary judgment to the defendants). It is worth noting that both Judge Johnson and Judge Clark stated that the question of whether a security was unmarketable is a question of fact for the jury, not a matter of law for the judge. *Id.* at 746-47 (Johnson, J., dissenting); *id.* at 747 (Clark, J., dissenting); *see also id.* (Hatchett, J., dissenting) (agreeing with Judges Johnson and Clark that the case presented a "disputed issue of material fact").

178. 844 F.2d 1485, 1488-89 (11th Cir. 1988). The Fifth Circuit had been previously split into the Fifth and the Eleventh Circuits. *Supra* note 163.

179. *Shores II*, 844 F.2d at 1493; *supra* note 164.

180. 714 F. Supp. 132 (E.D. Pa. 1989), *aff'd*, 897 F.2d 524 (1990) (decision without published opinion). The plaintiffs purchased municipal revenue bonds issued for the purpose of building a retirement center, which subsequently defaulted on its payment. *Id.* at 133-34. The plaintiffs claimed, among other things, that the offering documents intentionally did not contain information regarding the lack of necessary working capital to finance the project, and that the defendants made fraudulent promises that they would support the endeavor. *Id.* at 134.

181. *Id.* at 138.

182. *See id.* at 137-38.

183. *Id.* at 138.

presumption."[184] The court's language of "warranting application of the fraud-created-the-market presumption" implies that if the appropriate facts were before the court, it would formally adopt the fraud-created-the-market theory.[185]

The following year, the Eastern District of Pennsylvania produced a similar result in *In re Bexar County Health Facility Development Corp. Securities Litigation*.[186] Again, the court found that the facts before it did not warrant the application of the theory.[187] The court held that a plaintiff must prove that the security in question "could not have been marketed at any . . . price" in order to be granted a presumption of reliance under the fraud-created-the-market theory.[188] The court relied on the *Ross* court's approach to economic unmarketability, noting that *Ross* required the plaintiff to prove that the security was inherently worthless.[189] The court's conclusion strongly suggests that it did not reject the overall validity of the theory.[190]

For the third time in three years, the same district court addressed this issue in *Gruber v. Price Waterhouse*.[191] The court held that the plaintiffs did not meet the reliance requirement of a private securities fraud action under Rule 10b-5 of the Exchange Act because they were unable to sustain the claim that the defendants' fraud created that particular security's market.[192] This decision, however, was also not an express rejection of the theory and, as in the earlier Eastern District cases, it contained language implying that, given the proper facts, the court would apply the theory.[193] The language used in all three

184. *Id.*

185. *Id.*

186. 130 F.R.D. 602 (E.D. Pa. 1990) (deciding that because the project underlying the bonds, despite being bankrupt, had some value and would return at least a minimal amount to its investors, the plaintiffs could not use the fraud-created-the-market theory because the securities were not patently worthless or a complete sham).

187. *Id.* at 611.

188. *Id.* The plaintiffs had alleged that the disclosure documents did not contain information regarding the two previous failed attempts to raise financing capital by the issuer for other projects. *Id.* at 604.

189. *Id.* at 609.

190. *Id.* at 611. The court even went so far as to note the Third Circuit's affirmation of *Stinson*. *Id.* at 610; *see supra* note 180.

191. 776 F. Supp. 1044 (E.D. Pa. 1991). The plaintiffs sued the accounting firm that audited the financial statements of the company whose stock the plaintiffs had purchased. *Id.* at 1045-46. The plaintiffs claimed that fraudulent audits performed by the defendant produced intentionally misstated financial statements. *Id.*

192. *Id.* at 1053-54. The plaintiffs had also put forth theories of reliance based upon actual reliance, the *Affiliated Ute* presumption of reliance, and the fraud-on-the-market theory presumption of reliance. *Id.* at 1047, 1049; *see supra* Parts I.B.1, I.B.2. The court held that they failed to establish reliance under any of these claims. *Gruber*, 776 F. Supp. at 1049, 1051-52.

193. *See Gruber*, 776 F. Supp. at 1052-53. (using such language as "[t]herefore, 'fraud-created-the-market' only applies where the underlying business is an absolute sham, worthless from the beginning" and "[i]n this instance, it would be inappropriate to presume reliance under the 'fraud-created-the-market doctrine'").

Eastern District of Pennsylvania cases, however, appears to be in agreement with the Eleventh Circuit's view of strict interpretation of economic unmarketability.[194]

5. The Ninth Circuit: Reliance on the Regulatory Body

The Ninth Circuit was presented with a somewhat unusual argument in *Arthur Young & Co. v. District Court*[195] a few years before the emergence of the fraud-created-the-market theory in *Shores*. The petitioners were defendants in the district court proceeding and had requested the de-certification of the plaintiffs' class.[196] The plaintiffs claimed the defendant made a variety of material misrepresentations in numerous disclosure documents and offering statements regarding the sale and multiple subsequent transfers of shares in oil and gas exploration entities.[197] The court, relying on its earlier decision in *Blackie v. Barrack*,[198] held that an initial investor of securities "relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies . . . at the time of the original issue."[199] As with legal and economic unmarketability standards, the court recognized that but for the defendant's fraud, the securities could and would not have been issued. Under "reliance on the regulatory body" the Ninth Circuit granted plaintiffs a presumption of reliance based on the registration of a new security with a regulatory body, usually the SEC.[200]

This variation on a presumption of reliance has not been well received by other courts.[201] Critics' primary concern is that regulatory bodies, particularly the SEC, do not perform any type of evaluation or due diligence on a securities offering when it is registered.[202] While an investor may not rely on a regulatory body to guarantee an issuer's disclosures, he or she may assume that such statements are

194. *See supra* notes 170-73 and accompanying text.

195. 549 F.2d 686 (9th Cir. 1977).

196. *Id.* at 687-88.

197. *Id.* at 688-89.

198. 524 F.2d 891, 906 (9th Cir. 1975) (removing the substantial burden of proving reliance when it involves publicly traded securities).

199. *Arthur Young*, 549 F.2d at 695.

200. *See id.*

201. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 251 & n.2 (1988) (White, J., concurring and dissenting); Joseph v. Wiles, 223 F.3d 1155, 1165-66 (10th Cir. 2000) (noting the court's concern that this would create investors' insurance).

202. *Joseph*, 223 F.3d at 1165-66; Snow, *supra* note 54, at 947 (stating that "because regulators do not pass on the appropriateness of an IPO offering price, or on legal sufficiency of disclosures in a prospectus, the analytical underpinning for the *Arthur Young* presumption—the existence of a regulatory process capable of making these determinations—would appear to be absent"); *supra* note 138 (detailing the disclosure required by the SEC regarding the absence of any qualitative review of offering documents); *see* Herzog, *supra* note 79, at 381.

trustworthy. The Tenth Circuit commented that to presume that the issuance of securities guarantees a minimal level of value contravenes the idea that registration of securities with regulatory bodies is an enforcement of disclosure requirements, not a guarantee of reliability.[203] The Ninth Circuit contended, however, that investors are able to rely on the issuing process as a minimal guarantee of marketability.[204]

Critics also contend that the Ninth Circuit's approach is remarkably similar to legal unmarketability, and thus, creates the same problems attributed to the fraud-created-the-market theory.[205] While the theory is rooted in the same concepts as the fraud-created-the-market theory, the difference lies in that the *Arthur Young* presumption of reliance focuses on the fraudulent "representations made to the appropriate agencies and the investors,"[206] which resulted in the security being issued. In contrast, the legal unmarketability standard, as set out by the Tenth Circuit in *T.J. Raney*, focuses on whether the issuing entity deliberately bypassed certain steps in the regulatory process of issuing securities.[207]

A plaintiff attempting to use the *Arthur Young* presumption is relying on a regulatory body, primarily the SEC, as evidence of an offering circular's veracity, but the Tenth Circuit in *T.J. Raney* was not concerned with a plaintiff's reliance on statements made to any regulatory bodies. In the Ninth Circuit, the presumption rests upon the theory that the SEC has in some way given credence to the accuracy of a company's statements, on which the plaintiffs may therefore rely. Legal unmarketability, by contrast, claims that the company, as the issuing entity, simply had no legal right to issue the securities, regardless of what statements it made to the SEC.

B. *Circuits Refuting Fraud-Created-the-Market*

While a number of circuits have either expressly or implicitly accepted the fraud-created-the-market theory, the Sixth and the Seventh Circuits have questioned aspects of the fraud-created-the-market theory as contrary to a policy of full disclosure to investors. Yet even these circuits do not completely reject the fraud-created-the-market theory, and their resistance to the theory appears to be based on a misunderstanding of the theory rather than a rejection of principles underlying it.

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203. *Joseph*, 223 F.3d at 1156-66.

204. *Arthur Young*, 549 F.2d at 695.

205. *E.g.*, Herzog, *supra* note 79, at 393-94.

206. *Arthur Young*, 549 F.2d at 695.

207. *Supra* notes 133-37 and accompanying text. In legal unmarketability, the only misrepresentation an issuer makes is the implicit representation that because the securities are in the market, they were issued according to the proper regulatory procedures. *See Joseph*, 223 F.3d at 1165-66.

1. The Sixth Circuit

In *Freeman v. Laventhol & Horwath*,[208] the Sixth Circuit was faced with deciding the validity of the fraud-on-the-market theory as applied to inefficient primary markets.[209] The court held that the presumption of reliance created by the fraud-on-the-market theory in *Basic Inc.* only applies to efficient markets because a defendant's fraudulent misrepresentations will only be incorporated into the market price in an efficient market.[210] The market for certain newly-issued securities such as tax-exempt municipal bonds, on the other hand, is inherently inefficient because the market has not yet evaluated the bond's worth, but reflects only the issuer's pricing of the securities.[211] While this appears to directly refute the *Shores* holding, which appeared to extend the fraud-on-the-market theory to the primary markets, the court expressly chose not to reject the fraud-created-the-market theory.[212] After reviewing the history of the fraud-created-the-market theory, the *Freeman* court declared that it "is separate and distinct from the fraud on the market theory, and is supported by an entirely different rationale."[213]

While the majority chose not to address the fraud-created-the-market theory, Judge Guy stated in a separate opinion that the lower court was in fact asking this court to decide the status of the theory in the Sixth Circuit.[214] His opinion stated that "I would join with the courts that have recognized" the fraud-created-the-market theory as a valid presumption of reliance.[215]

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208. 915 F.2d 193 (6th Cir. 1990). The plaintiff class represented all investors of the tax-exempt municipal bonds issued to raise the necessary capital to build a retirement center in Kentucky. *Id.* at 196. The plaintiffs claimed that there were numerous fraudulent statements in the prospectus regarding the project's lack of financial viability. *Id.* The project filed for bankruptcy after only seven of the 175 residential units were sold. *Id.* The bankruptcy plan provided for the investors to receive an estimated fifty-five percent of their initial invested capital. *Id.* Because the bondholders were set to recover a significant portion of their money, the court could have followed the lead of *Ockerman* and decided that this alone was sufficient to prevent the plaintiff from meeting the economic unmarketability standard. *See supra* note 152 and accompanying text; *infra* notes 233-34 and accompanying text; Rosenthal v. Dean Witter Reynolds, Inc., 945 F. Supp. 1412, 1418-19 (D. Colo. 1996).

209. *Freeman*, 915 F.2d at 197; *see supra* notes 72-73 and accompanying text for discussion of efficient markets.

210. *Freeman*, 915 F.2d at 197-98.

211. *Id.* While issuers generally set the issuing price of a new stock in the fifteen to twenty-five dollars per share range, they will often also consider anticipated investor interest in the security. If the issue is going to be a "hot issue," the issuer will fix the original price somewhat higher, at a premium. Conversely, if there is little market interest in the security, the issuing price may be set lower than normal at a discount. Thus, while the issuer has complete control over the original price, the market does have influence over the pricing.

212. *Id.* at 199.

213. *Id.* at 200.

214. *Id.* at 200-01 (Guy, J., concurring in part and dissenting in part).

215. *Id.* at 200 (Guy, J., concurring in part and dissenting in part).

Four years later, this presumption of reliance was directly at issue before the Sixth Circuit in *Ockerman v. May Zima & Co.*[216] The circuit court overturned the district court's grant of a presumption of reliance to the plaintiff under the fraud-created-the-market theory in a primary issue.[217] Its analysis began with affirming the *Freeman* court's rejection of the fraud-*on*-the-market theory for certain types of securities, specifically initial offerings of municipal bonds.[218] The *Ockerman* court further discussed that the fraud-*created*-the-market theory conflicted with the holding in *Freeman*, despite the *Freeman* court's express avoidance of ruling on the fraud-created-the-market theory.[219] The court appeared to misapply economic unmarketability, however, by stating that its main difficulty with accepting the theory was that the market does not control the price of a newly-issued security and that all available public information is not incorporated into the price.[220] These factors are irrelevant both to "economic unmarketability" in particular, and to the fraud-created-the-market theory in general.[221] The court proceeded to recognize other circuits' application of the fraud-created-the-market theory if a security could not have been marketed "but for the defendant's fraud" and if there was reliance on the market.[222]

The Sixth Circuit also refuted the district court's reasoning that Rule 10b-5(a) and (c) themselves create a presumption of reliance because it was concerned that this completely removed reliance as a prerequisite to Rule 10b-5(a) and (c) causes of action.[223] The court

216. 27 F.3d 1151 (6th Cir. 1994). Plaintiffs purchased mortgage revenue bonds issued by the city of Bowling Green, Kentucky, which were issued to finance the construction of a retirement facility. *Id.* at 1153. As in *Freeman*, here the plaintiffs alleged that the offering documents contained a number of misrepresentations of the financial situation supporting the project and the defendants themselves. *Id.* at 1153-54. Again similar to the facts in *Freeman*, this project failed because of a lack of a market for the housing units. *Id.* at 1154; *see also Freeman*, 915 F.2d at 196. Only approximately $485,000 was paid back to the investors through the bankruptcy plan out of a combined initial investment of $5.5 million. *Ockerman*, 27 F.3d at 1153.

217. *Ockerman*, 27 F.3d at 1158 (noting that the lower court held that Rule 10b-5 of the Exchange Act was intended to give the plaintiff a presumption of reliance on the "integrity of the defendants' scheme and course of business in issuing the securities in question" (quoting Ockerman v. May Zima & Co., 785 F. Supp. 695, 703 (M.D. Tenn. 1992))).

218. *Id.* at 1158-59 (citing *Freeman*, 915 F.2d at 193, 198). For a definition of municipal bonds, see *supra* note 97.

219. *Ockerman*, 27 F.3d at 1159; *see also supra* note 212 and accompanying text.

220. *Ockerman*, 27 F.3d at 1159.

221. Complete assimilation of information into a security's market, however, is one of the basic foundations of the fraud-*on*-the-market theory, not the fraud-*created*-the-market theory. *See supra* notes 72-73 and accompanying text.

222. *Ockerman*, 27 F.3d at 1159 (citing Ross v. Bank South, N.A., 885 F.2d 723 (11th Cir. 1989) (en banc)); T.J. Raney & Sons, Inc. v. Fort Cobb Okla. Irr. Fuel Auth., 717 F.2d 1330 (10th Cir. 1983); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc).

223. *Ockerman*, 27 F.3d at 1161-62. Direct reliance is still required in Rule 10b-5(b) causes of action. *Supra* note 92 and accompanying text.

expressed its view that such an interpretation would create the infamous "investor's insurance" by essentially guaranteeing an investor recovery.[224] It relied on Justice White's dissent in *Basic Inc.*, who was troubled that such a presumption of reliance would "'permit[] recovery by a plaintiff who claims merely to have been harmed by a material misrepresentation which altered a market price.'"[225] Justice White, however, was concerned with a "material misrepresentation which *altered* a market price,"[226] while the crucial focus of the fraud-created-the-market theory is not securities that have intentionally altered market prices, but securities with a completely fraudulent market price. The fraud-*on*-the-market theory presumes reliance in situations of intentionally mispriced securities, while the fraud-*created*-the-market theory presumes reliance in situations where securities are intentionally fraudulently marketed.[227]

The *Ockerman* court further discussed the problem of establishing a clear definition of "unmarketable."[228] It noted, as other courts have,[229] that unmarketability can be both economic and legal.[230] It provided a clear description of economic unmarketability, focusing on the concept of an enterprise with no assets to support it, following the Eleventh Circuit and the Eastern District of Pennsylvania.[231] In *Ockerman*, the Sixth Circuit chose, however, to avoid adjudicating whether this specific presumption of reliance applied to newly-issued securities.[232] Although the plaintiffs failed to claim that the bonds were patently worthless, the court *sua sponte* rejected that possibility.[233] Despite the bankruptcy of the entity, some of its assets were sold and the bondholders recovered minimal amounts of their investment.[234]

The court chose not to address the legal unmarketability of the securities because the plaintiffs also failed to allege the issue in their claim.[235] Accordingly, the court concluded by stating, "we neither adopt nor reject that theory since to do so would be advisory.... [T]herefore, [we hold] that a presumption of reliance based on a fraud created the market theory of the Fifth and Eleventh Circuits is

224. *Id.* at 1162.
225. *Id.* (quoting Basic Inc. v. Levinson, 485 U.S. 224, 251 (1988) (White, J., dissenting)) (emphasis omitted).
226. *Id.* (quoting *Basic Inc.*, 485 U.S. at 251 (White, J., dissenting)) (emphasis added).
227. Joseph v. Wiles, 223 F.3d 1155, 1163 n.2 (10th Cir. 2000).
228. *Ockerman*, 27 F.3d at 1160.
229. *See, e.g.*, *Joseph*, 223 F.3d at 1165.
230. *Ockerman*, 27 F.3d at 1160.
231. *See id.*; *supra* notes 170-73, 189 and accompanying text.
232. *Ockerman*, 27 F.3d at 1160.
233. *Id.*
234. *Id.* at 1153.
235. *Id.* at 1160-61.

unavailable to plaintiff in this case."[236] It appears that, despite its earlier language in *Freeman*, the circuit's position on the theory is not yet fully developed.

2. The Seventh Circuit

Subsequent to *Freeman*, but prior to *Ockerman*, the Seventh Circuit was presented with a claim of a presumption of reliance on the fraud-created-the-market theory in *Eckstein v. Balcor Film Investors*.[237] The court first acknowledged the current disagreement between the circuits.[238] It concluded that the Sixth Circuit's holding in *Freeman* was the appropriate stance on this presumption of reliance.[239] The court repudiated the Fifth Circuit's decision in *Shores*, describing it as "simply false."[240] The court's primary dispute with *Shores* was that a private plaintiff relying solely on the issuance of a particular security is not the same as an investor relying on information disclosed in a prospectus.[241] The court in *Eckstein* noted that inadequate disclosures do not by themselves prevent a security's issuance.[242] In what appears to be confusion with the fraud-on-the-market theory, it stated that the market transacts in numerous securities despite improper disclosure by the issuers of those securities.[243] The court went on to state that "[f]ull disclosure of adverse information may lower the price, but it does not exclude the security from the market."[244] The court focused on fraudulently mispriced securities, not patently worthless securities that should not be on the market because they represent a completely bogus entity.[245]

While the *Eckstein* court did not specifically discuss economic unmarketability, it commented on legal unmarketability at least

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236. *Id.* at 1161.

237. 8 F.3d 1121 (7th Cir. 1993). *Eckstein* is a complex securities case involving two classes of plaintiffs, the Majeski plaintiffs and the Eckstein plaintiffs. *Id.* at 1123. The Majeski plaintiffs were purchasers of partnership interests who had relied on the prospectuses, while the Eckstein plaintiffs were investors who had not relied on the prospectus. The defendants, the issuers of the partnership interests, failed to raise the required minimum capital of fifty million dollars and reduced that amount to thirty-five million. After two years of operations, the defendant informed investors of the likelihood of a partial capital loss. The relevant class for the fraud-created-the-market theory is the Eckstein plaintiffs, who alleged, among other things, that "but for the misrepresentations and omissions the offering would not have been successful." *Id.* At least one critic of the theory cites *Eckstein* as a clear rejection of it. Herzog, *supra* note 79, at 383-86.

238. *Eckstein*, 8 F.3d at 1130.

239. *Id.*; *see supra* notes 208-11 and accompanying text.

240. *Eckstein*, 8 F.3d at 1131.

241. *Id.*

242. *Id.* at 1130.

243. *Id.* at 1130-31.

244. *Id.* at 1131.

245. *See supra* notes 226-27 and accompanying text.

indirectly.[246] The court noted that if the plaintiffs had proved that absent the fraud the defendants could not have met the minimum investment capital amount, then the defendants could not have legally issued the partnership interests.[247] With this statement, the court appeared to be agreeing with the "unlawfully issued" standard of the Tenth Circuit in *T.J. Raney*,[248] but the *Eckstein* plaintiffs failed to prove such an allegation.[249]

The *Eckstein* court's opinion symbolized the Sixth and Seventh Circuits position on the fraud-created-the-market theory. While the circuits ostensibly rejected the theory, their opinions indicated both a misapplication of the theory and a willingness to consider its validity in certain situations, such as in the fraudulent issuance of patently worthless securities. In contrast, the circuits expressly accepting the fraud-created-the-market theory have established that it may be applied in situations where a security is either economically or legally unmarketable.[250] While the Tenth Circuit in *T.J. Raney* was the only circuit to primarily focus on legal unmarketability, two versions of economic unmarketability developed in the Eleventh and Third Circuits, and the Fifth Circuit.[251]

This Note argues that the Fifth Circuit's more flexible standard of patently worthless securities provides the proper view of economic unmarketability. That standard and the Tenth Circuit's standard of legal unmarketability are the appropriate methods for courts to apply the fraud-created-the-market theory, as the next part will discuss. This presumption of reliance is necessary considering the original intent of the Acts to have honest and fair markets, combined with the continual proliferation of fraudulent securities issues in traditional markets and the emergence of the Internet as a securities market.

III. THE FRAUD-CREATED-THE-MARKET THEORY IS A VALID PRESUMPTION OF RELIANCE

The fraud-created-the-market theory is still a work in progress. The courts are continuing to clarify not only the validity of the theory, but how and when it is to be properly applied.[252] Opponents of the theory

246. *See Eckstein*, 8 F.3d at 1131.
247. *Id.*
248. 717 F.2d 1330 (10th Cir. 1983); *see supra* notes 133-35 and accompanying text.
249. *Eckstein*, 8 F.3d at 1131.
250. *Supra* Part II.A.
251. *Supra* Parts II.A.1-A.4.
252. Not all of the circuits have taken an express position on the validity of the fraud-created-the-market theory. For example, the Eighth Circuit, in *In re NationsMart Corp.*, 130 F.3d 309 (8th Cir. 1997), failed to answer the question of the fraud-created-the-market theory's validity. Plaintiffs, purchasers of NationsMart stock, alleged, among other things, that the defendants made material omissions and false statements in the prospectus. *Id.* at 314. The court held that the plaintiffs could not presume reliance because they failed to properly allege sufficient facts to support

assert that any application of the fraud-created-the-market theory is unacceptable because it violates the statutory purpose of the Acts by de-emphasizing the importance of disclosure in market regulation.[253] According to these critics, the Acts were passed with the express purpose of using disclosure to create a system of self-regulation.[254] The overall goal of the Acts is contravened if private plaintiffs are relieved of their burden of proving direct reliance on either disclosure or lack of disclosure, for it will create unconcerned and passive investors who will stop reading prospectuses and other disclosure documents to determine an investment's value. The critics most greatly fear that this theory would virtually guarantee any investor recovery for a failed investment, which would open the floodgates to litigation.[255]

Yet these critics fail to realize that when properly applied, as in *Abell*[256] and *Joseph*,[257] the fraud-created-the-market theory directly flows from the purpose of the Exchange Act, which is to create and maintain an honest and fair securities market.[258] By itself, disclosure is an insufficient regulatory structure because investors cannot completely analyze all of the information in the marketplace, and thus they can not properly evaluate potential investment opportunities.

Finally, the fraud-created-the-market theory is necessary because of the growing number of unmarketable securities, especially patently worthless ones, that are now being offered over the Internet in addition to the conventional markets.

The fraud-created-the-market theory should be applied in situations where it would not only be unduly burdensome but also irrelevant for a plaintiff to establish his or her actual reliance on a defendant's false statements. Courts have balanced granting such a presumption of reliance with the significant burden of proving a defendant's intent to defraud in order to prevent abuse by plaintiffs of the theory.[259] Private plaintiffs need to be granted this presumption of reliance whenever an entity has no intention to have its security represent an investment in a legitimate and potentially viable enterprise or in an enterprise with the legal authority to issue that security.

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application of the fraud-created-the-market theory. *Id.* at 322. The court did not use language that strongly implied it would accept such a theory, but neither did it use language implicitly rejecting it. *Id.* at 321-22.

253. Shores v. Sklar, 647 F.2d 462, 472-73 (5th Cir. 1981) (en banc) (Randall, J., dissenting); Herzog, *supra* note 79, at 362, 387, 390, 396-98.

254. *Shores*, 647 F.2d at 472-73 (Randall, J., dissenting); Herzog, *supra* note 79, at 387, 390, 396-98.

255. *Shores*, 647 F.2d at 472-73 (Randall, J., dissenting); Herzog, *supra* note 79, at 362.

256. *Supra* notes 126-32 and accompanying text.

257. *Supra* notes 147-62 and accompanying text.

258. *Infra* Part III.B.1.

259. *Infra* notes 321-25 and accompanying text.

A. *Proper Application of the Fraud-Created-the-Market Theory*

Since the *Shores* decision, courts have applied several versions of the fraud-created-the-market theory.[260] The Fifth Circuit's approach to economically unmarketable securities as stated in *Abell* is the proper standard to determine whether a security is patently worthless.[261] The court correctly focused on examining the issuer's intent to decide whether the plaintiff would be granted this presumption of reliance.[262] Courts should determine whether the purpose of marketing a new security is to provide needed capital to finance an honest business or simply to perpetrate a complete sham.[263] If a defendant had no plans to operate an actual enterprise, it does not matter what, if any, disclosures were made and whether an investor had relied on them. This is what separates the fraud-created-the-market theory from the fraud-on-the-market theory. When a party intentionally alters the market price of a security that is already trading in the market, the fraud-on-the-market theory grants a presumption that the market price is accurate.[264] Fraud-created-the-market, however, grants a presumption of reliance if a party intentionally issues a security that should not be issued at any price.[265] The fraudulent intent renders proof of actual reliance unnecessary because the plaintiff would have suffered a financial injury whether or not he or she had relied on offering documents and disclosure statements.

Part of the original intent of the Exchange Act is for courts to be flexible in adopting Rule 10b-5. The Fifth Circuit correctly adhered to the doctrine of flexibility, balancing it with the concerns that overbroad application of the fraud-created-the-market theory could potentially create the investors' insurance feared by some.[266] In deciding whether a security was patently worthless, *Abell* implied that courts should apply a certain amount of flexibility.[267] The court was not as strict as other circuits, which require an absolute absence of any assets underlying the security in order for a plaintiff to allege that the fraud created the market.[268] The court properly recognized that

260. *Supra* Parts I.C, II.A.
261. *Supra* notes 128-32 and accompanying text.
262. *Supra* note 128 and accompanying text.
263. The level of risk involved in an investment is not a factor in determining whether a plaintiff is eligible for this presumption of reliance. An issuer raising capital to fund a high-risk venture, such as an Internet start-up company, is not the type of entity, if it subsequently fails, that a plaintiff could bring a Rule 10b-5 cause of action against and be granted a presumption of reliance under the fraud-created-the-market theory because there was no intent to defraud.
264. *Supra* notes 71-73 and accompanying text.
265. *Supra* notes 107-08 and accompanying text.
266. *Infra* Part III.B.1.
267. *Supra* note 129 and accompanying text.
268. *See, e.g., supra* notes 170-73, 189 and accompanying text.

"saleable assets may bless even the most worthless enterprise."[269] For example, as noted by the *Abell* court, the defendants in *Shores* clearly intended to defraud investors with unmarketable securities, despite the presence of some assets in the entity underlying the security.[270] The Eleventh Circuit's stricter, absolute approach to patently worthless securities as expressed in *Ross*[271] does not provide courts the needed flexibility to apply the fraud-created-the-market theory in situations where, even if there were minimal assets in an entity, potential defendants had no intention to operate an economically marketable business.

The Tenth Circuit in *Joseph*, clarifying its holding in *T.J. Raney*, established the correct standard for examining legal unmarketability.[272] The Tenth Circuit's definition of legal unmarketability created a minimum baseline of reliance that the issuing corporation had the proper legal authority to offer the securities, and did not intentionally bypass one of the steps set forth by regulatory bodies in order to legally issue the securities.[273] For example, municipal revenue bonds need to be issued through a properly formed trust.[274] If a defendant had intentionally and improperly formed the trust, he or she would not have the legal authority to issue the bonds, even if the project was financially viable. An investor in this model does not assume that a regulatory agency has guaranteed the market price of the security, but merely presumes that the issuer has not fraudulently offered the securities in violation of regulations.[275]

The fraud-created-the-market theory is particularly appropriate in allowing a plaintiff a presumption of reliance in a class action under Rule 10b-5, when it is difficult to prove that the entire class relied on disclosure documents.[276] Without such a presumption, a class of injured investors would either be unable to use the class action forum to seek a remedy or would be burdened with the task of establishing direct reliance for each of the many individuals in the class. The fraud-created-the-market theory is ideal for class actions because of the efficiency of creating a common presumption of reliance for all class members.[277] Courts have found that it is appropriate to certify

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269. Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122 (5th Cir. 1988).

270. *Id.* (discussing Shores v. Sklar, 647 F.2d 462, 465-67 (5th Cir. 1981) (en banc)); *see also supra* notes 127-28 and accompanying text.

271. Ross v. Bank South, N.A., 885 F.2d 723, 729-30 (11th Cir. 1989). The Third and Sixth Circuits also apply the same standard. *Supra* notes 193-94, 231-34 and accompanying text.

272. *Supra* notes 157-58 and accompanying text.

273. Joseph v. Wiles, 223 F.3d 1155, 1164-65 (10th Cir. 2000).

274. *Supra* note 136 and accompanying text.

275. *Supra* note 138.

276. *Supra* notes 164, 178-79 and accompanying text.

277. Kirkpatrick v. J.C. Bradford & Co., 827 F.2d 718, 722-23 (11th Cir. 1987).

plaintiff classes in fraud-created-the-market cases because the different levels of actual reliance between individual class members is either "immaterial" or "virtually irrelevant."[278]

Critics of the fraud-created-the-market theory hold that the Seventh Circuit's decision in *Eckstein* and the Sixth Circuit's decisions in *Freeman* and later in *Ockerman* properly rejected the fraud-created-the-market theory's validity.[279] These critics, however, have misread the *Freeman* decision as a rejection of the theory, and furthermore, the courts in *Ockerman* and *Eckstein* were incorrect in their dismissal of the fraud-created-the-market theory. In the earliest of the three cases, the *Freeman* court expressly stated that it was not rejecting the fraud-created-the-market theory.[280] It made a clear distinction between the fraud-created-the-market theory and the fraud-on-the-market theory.[281] While the court would not presume reliance in an inefficient secondary market, it did state that the fraud-created-the-market theory was "supported by an entirely different rationale."[282]

The Seventh Circuit's decision in *Eckstein* clearly relied on *Freeman*.[283] The *Eckstein* court interpreted the Sixth Circuit's holding in *Freeman* as a complete rejection of this theory, despite the Sixth Circuit's express avoidance of that very issue.[284] Additionally, the Seventh Circuit arguably misapplied the underlying rationale of *Shores*. As noted above, it described the "linchpin of *Shores*" to be simply that "disclosing bad information keeps securities off the market."[285] The plaintiffs in *Eckstein* did not meet the unmarketability requirements of the theory because they failed to prove that the partnership interests were issued illegally and failed to allege that the securities were patently worthless.[286] The *Eckstein* court, however, did not recognize that *Shores* and its progeny did not merely reiterate the importance of full disclosure to the market but, more importantly, established the fraud-created-the-market theory to apply to securities that could not have been marketed absent a defendant's intentional fraud.[287]

The Seventh Circuit erred in assuming that a party intending to commit a completely fraudulent offering would be motivated to disclose this "bad information." While disclosing negative

278. Shores II, 844 F.2d 1485, 1493 (11th Cir. 1988); *Kirkpatrick*, 827 F.2d at 723.
279. Herzog, *supra* note 79, at 383-86; *see* Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130-31 (7th Cir. 1993).
280. Freeman v. Laventhol & Horwath, 915 F.2d 193, 199 (6th Cir. 1990).
281. *Id.* at 200.
282. *Id.*
283. *Eckstein*, 8 F.3d at 1130.
284. *Id.*; *supra* notes 280-81 and accompanying text.
285. *Eckstein*, 8 F.3d at 1131; *supra* Part II.B.2.
286. *Eckstein*, 8 F.3d at 1130-31.
287. *See supra* Parts I.C, II.A.

information may prevent an artificial increase in the value of a security traded on the market, it will not prevent the security from being issued. The court used the underlying principles of the fraud-on-the-market theory as set forth in *Basic Inc.*,[288] and therefore may have confused the distinction between fraud-on-the-market and fraud-created-the-market.[289] The court incorrectly focused on manipulated market prices of securities, not on fraudulent securities that should never have entered the market.

Subsequently, the Sixth Circuit in *Ockerman* similarly misapplied the fraud-on-the-market theory to a fraud-created-the-market cause of action in relying on Justice White's dissent in *Basic Inc.* regarding a security's market value being affected by a material misrepresentation.[290] The fraud-created-the-market theory is not available for plaintiffs seeking to recover for a loss due to fraudulently mispriced securities, but rather for a loss due to securities that never would have been issued but for the defendant's fraud.[291] The court criticized the fraud-created-the-market theory because a security's issuing price may not accurately represent its value because the issuers have different motivation than investors.[292] This criticism is misplaced, however, because the fraud-created-the-market theory is not concerned with accurate pricing of securities, even in initial offerings, but with the intentionally fraudulent securities issued at any price.[293]

B. *The Underlying Rationale of the Fraud-Created-the-Market Theory*

1. Statutory Purpose

Some have stated that the fraud-created-the market theory clashes with the original intent of the Exchange Act.[294] Critics of the theory feel that the overriding purpose of the Acts was to encourage full and fair disclosure by securities issuers, thus creating a level playing field for investors.[295] The dissent in *Shores* argued that Congress, in passing

288. *Supra* Part I.B.2.

289. *Supra* note 82.

290. Ockerman v. May Zima & Co., 27 F.3d 1151, 1162 (6th Cir. 1994).

291. *Supra* notes 101, 107-08 and accompanying text.

292. *Ockerman*, 27 F.3d at 1159.

293. *See id.* at 1158-59 (discussing both the fraud-on-the-market and the fraud-created-the-market theory).

294. Shores v. Sklar, 647 F.2d 462, 473-74 (5th Cir. 1981) (en banc) (Randall, J., dissenting).

295. *Id.* at 482 (Randall, J., dissenting); *see also Ockerman*, 27 F.3d at 1161-62; Herzog, *supra* note 79, at 390. For an alternative theory on the intended purpose of the Exchange Act aside from the full and fair disclosure approach, see generally Thel, *supra* note 14.

the Acts, only intended complete disclosure of accurate information.[296]

Yet the intent of the Exchange Act was not to create a fully educated and active investor, but rather to maintain the highest level of integrity in the markets and to ensure investor protection against fraudulent schemes and devices.[297] When the Exchange Act was proposed, one of its original authors stated that Section 10(b) "was 'a catch-all clause to prevent manipulative devices.'"[298] As noted recently by the SEC's Director of Enforcement, Richard H. Walker, "the antifraud prohibitions have to be expansive in order to address the evolving world of manipulative schemes."[299] The Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*[300] held that the Exchange Act was designed "'to prevent inequitable and unfair practices on such exchanges and markets.'"[301] Just a year later, the Court stated that the Acts' purposes were "to protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing."[302] While it is clear that active and educated investors can help maintain a sound market, full disclosure is just one piece of a comprehensive policy of market integrity.[303] Investors, particularly individuals, are not in a position to thoroughly analyze all of the publicly available information on securities. Most individuals lack the knowledge and the time to perform a complete analysis of a security's weaknesses, even if there is no fraud or wrongdoing on the issuer's part.

In order to adhere effectively to the intent of investor protection, courts must be able to flexibly apply Rule 10b-5 to the types of scenarios where the security would not and should not have been issued at all. For at least thirty-five years the Supreme Court has espoused this "flexible" view. Beginning with its holding in *SEC v. Capital Gains Research Bureau, Inc.*,[304] the Supreme Court stated that securities legislation was "intended . . . to be . . . 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but

296. *Shores*, 647 F.2d at 481-82 (Randall, J., dissenting).

297. John Schmidt, Comment, *The Fraud-Created-The-Market Theory: The Presumption of Reliance in the Primary Issue Context*, 60 U. Cin. L. Rev. 495, 519-20 (1991) (noting that "the [acts'] central goal is to protect investors from fraudulent conduct, and to promote honest securities markets").

298. Richard H. Walker, Regulation vs. Enforcement in an On-Line World, Address Before The Bond Market Association's 6th Annual Legal and Compliance Seminar 3 (Oct. 25, 2000), *available at* http://www.sec.gov/news/speech/spch413.htm.

299. *Id.*

300. 421 U.S. 723 (1975).

301. *Id.* at 728 (quoting the Exchange Act, 15 U.S.C. § 78a); *see* Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975) (stating that "[t]he statute and rule are designed to foster an expectation that securities markets are free from fraud"); *see also Shores*, 647 F.2d at 470.

302. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

303. *Shores*, 647 F.2d at 470.

304. 375 U.S. 180 (1963).

flexibly to effectuate its remedial purposes."[305] Subsequent to *Capital Gains*, the Court and other lower courts have consistently followed its flexible approach to Section 10(b) of the Exchange Act.[306]

Additionally, criticism regarding the intent of the Acts is misplaced because the fraud-created-the-market theory is consistent with a policy of full and fair disclosure in the market.[307] The Acts presume that the issuers have the burden to provide accurate information, rather than imposing on the investing public the burden of actively seeking out possible misrepresentations. The Acts were created to prevent the circumstances leading to the 1929 stock market crash, such as companies issuing worthless securities or allowing publicly traded companies to be managed with reckless disregard for shareholders' interests.[308] Company managers who are tempted to overstate assets or understate liability to artificially improve the company's financial results are potentially motivated instead to fully disclose negative information in order to prevent recrimination from the SEC as well as potential private causes of action under Rule 10b-5.[309] Parties seeking to perpetrate complete frauds, however, are not similarly motivated to disclose that their company is patently worthless because they have decided to risk the potential repercussions from the SEC or private plaintiffs. Mandatory full disclosure is irrelevant to such parties because their intent is to make misrepresentations to the public, attempting to persuade investors to purchase securities they would otherwise not purchase. In other words, "[w]ho would knowingly roll the dice in a crooked crap game?"[310] The fraud-created-the-market theory is necessary because it supplements a policy of full disclosure by granting a remedy to victims of the types of fraud that full disclosure would not prevent.

Furthermore, there is growing concern among securities regulators that a policy of full disclosure combined with modern communication

305. *Id.* at 195 (notes omitted) (quoting 3 Sutherland, Statutory Construction 382 (3d ed. 1943)) (comparing the Investment Advisers Act of 1940 to other securities legislation).

306. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728-30 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-51 (1972); Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 10-12 (1971); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); Lipton v. Documation Inc., 734 F.2d 740, 748 (11th Cir. 1984) (concluding that the *Shores* holding further allowed "a purchaser to rely on an expectation that the securities markets are free from fraud"); T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irr. Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983) (quoting Clegg v. Conk, 507 F.2d 1351, 1361 (10th Cir. 1974)); Shores v. Sklar, 647 F.2d 462, 470 (5th Cir. 1981) (en banc) (noting "the purposes of the securities acts and rule 10b-5 are far broader than merely providing full disclosure or fostering informed investment decisions").

307. Schmidt, *supra* note 297, at 520-21. The courts support this argument. *See, e.g.*, *Shores*, 647 F.2d at 470.

308. *See supra* notes 28-29 and accompanying text.

309. Schmidt, *supra* note 297, at 521.

310. Schlanger v. Four-Phase Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

technology may create the dangerous possibility of "too much information" being released upon the market.[311] The SEC is especially concerned that the Internet is becoming a source of "an unlimited amount of disclosure" with the potential to overwhelm investors with information, effectively eliminating the benefits of full disclosure.[312] SEC Commissioner Unger recently questioned whether all of the available information can be effectively filtered and interpreted by the average investor so it can be used properly.[313] A policy focused only on disclosure, which critics of the fraud-created-the-market theory support,[314] is not the most effective way to promote fair securities markets, and rigidly adhering to the full disclosure doctrine is not the solution to securities fraud problems. The fraud-created-the-market theory is necessary because if the investors are no longer able to rely on a company's representations, direct reliance becomes irrelevant. Indeed, "will [investors] be able to distinguish reliable information from the unreliable or even fraudulent information?"[315]

2. The Problem of Creating "Investors' Insurance"

Opponents of the doctrine believe it will create a new generation of passive and potentially negligent investors, because all burdens of researching a new security will be removed, thus allowing investors to assume that because a security is on the market, it is an inherently worthy investment.[316] The fraud-created-the-market theory, critics claim, creates a form of "investors' insurance," in which an investor is guaranteed against loss in any investment in a primary issue.[317] Critics contend that the theory will grant private plaintiffs unfettered

311. SEC Commissioner Laura S. Unger, Securities Law and the Internet, Address Before the Practicing Law Institute 3 (July 28, 2000), *available at* http://www.sec.gov/news/speech/spch395.htm [hereinafter Unger, Securities Law]; *see* SEC Commissioner Laura S. Unger, Rethinking Disclosure in the Information Age: Can There Be Too Much of a Good Thing?, Address at the Internet Securities Regulation American Conference Institute (June 26, 2000), *available at* http://www.sec.gov/news/speech/spch387.htm [hereinafter Unger, Disclosure].

312. Unger, Securities Law, *supra* note 311, at 2. Last year, according to the SEC, over half the country had access to the Internet in their homes. *Id.* The Internet is growing at an alarming rate. For example, in 1999, "one new web site was being established every minute and the number of Internet users and web pages doubled every 100 days." Unger, Disclosure, *supra* note 311, at 1.

313. Unger, Securities Law, *supra* note 311, at 2-3.

314. *Supra* notes 295-96 and accompanying text.

315. Unger, Disclosure, *supra* note 311, at 2.

316. Shores v. Sklar, 647 F.2d 462, 473, 483 (5th Cir. 1981) (en banc) (Randall, J., dissenting); Herzog, *supra* note 79, at 395-96.

317. *See Shores*, 647 F.2d at 473, 483 (Randall, J., dissenting); Herzog, *supra* note 79, at 395-96. The critics' worst case scenario is that every security would have to be a valid security *and* increase in value or the investor would have the fraud-created-the-market theory as a safety net to recover his or her investment.

opportunities to bring causes of action whenever a security proves to be unsuccessful.[318]

Yet safeguards are built into the fraud-on-the-market theory to prevent it from becoming "investors' insurance." First, the theory is a rebuttable presumption of reliance.[319] Courts have clearly stated that defendants may overcome the plaintiff's presumption of reliance, forcing the plaintiff to prove actual reliance or fail in his or her cause of action.[320]

Second, the requirement of scienter in Rule 10b-5 claims[321] provides strong protection from the potential dangers of creating investors' insurance because it is a significant barrier for plaintiffs to overcome.[322] The court in *Ross* commented that the burden of proving scienter is based on the first of the three requirements the *Shores* court established for a plaintiff to bring an action successfully under the fraud-created-the-market theory.[323] In legal unmarketability claims a plaintiff must not only establish that a defendant failed to adhere to a governmental regulation to be successful, but also that there was a malevolent intent.[324] An issuer is not automatically liable if it made an honest mistake. Similarly, if a plaintiff claimed that a security was economically unmarketable, the Fifth Circuit requires that the issuer "knew that the subject enterprise was worthless when the securities were issued."[325]

C. *The Theory is Necessary Because of the Growth of Internet Securities Fraud*

In the last few years the securities industry has entered the digital age via the World Wide Web. Issuers can interact with potential investors via the Internet with an ease and speed previously unheard of. For example, according to a recent speech by Commissioner Unger, in the year 2000 there were approximately twelve million

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318. *Shores*, 647 F.2d at 473 (Randall, J., dissenting).

319. This has its roots in the fraud-on-the-market theory, which is also a rebuttable presumption of reliance. *See* Basic Inc. v. Levinson, 485 U.S. 224, 248-49 (1988). For a discussion of how a defendant may rebut this presumption, see *supra* notes 74-78 and accompanying text.

320. *See, e.g.*, *In re* Bexar County Health Facility Dev. Corp. Sec. Litig., 130 F.R.D. 602, 607-08 (E.D. Pa. 1990).

321. *See supra* note 48.

322. *See* Ross v. Bank South, N.A., 885 F.2d 723, 729-30 (11th Cir. 1989); *In re Bexar*, 130 F.R.D. at 609.

323. *Ross*, 885 F.2d at 729. The court in *Ross* cited that "[u]nder *Shores*, a plaintiff must show that: (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed." *Id.*

324. T.J. Raney & Sons, Inc., v. Fort Cobb, Okla. Irr. Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1983) (stating "defendants knowingly conspired . . . with the intent to defraud").

325. Abell v. Potomac Ins. Co., 858 F.2d 1104, 1122-23 (5th Cir. 1988).

investors trading through on-line brokerage accounts.[326] On-line initial public offerings ("IPOs"), while still a small portion of the total IPO market, are quickly becoming a viable method to enter the market.[327] Likewise, the bond market is making its presence felt on the Internet.[328] The Federal Home Loan Mortgage Corporation[329] successfully completed its first bond offer via the Internet, raising approximately $6 billion, and the Internet is now seeing its first municipal bond offerings, as evidenced by a $530 million issuance by the Territory of Puerto Rico.[330]

The SEC has been adapting its approach in order to keep up with the rapid evolution of the securities industry. In October of 1995, the SEC, in a Securities Act Release,[331] clearly stated that "[t]he liability provisions of the federal securities laws apply equally to electronic and paper-based media. For instance, the anti-fraud provisions of . . . Rule 10b-5 . . . would apply to any information delivered electronically."[332] In July of 1996, the SEC granted a No-Action letter[333] to IPONET, a securities broker/dealer, in response to IPONET's desire to use the Internet to assist it in attracting investors.[334] This was the first time the SEC had allowed such activity, though it emphasized that the SEC's normal rules and regulation were still in effect.[335]

Unfortunately, with the growth of securities marketing and securities transactions on the Internet, securities fraud on the Internet has become more commonplace.[336] A significant portion of this fraud

326. SEC Commissioner Laura S. Unger, Empowering Investors in an Electronic Age, Address Before IOSCO Annual Conference 5 (May 17, 2000), *available at* http://www.sec.gov/news/speech/spch380.htm.

327. *Id.* at 9. (noting that during the last six months of 1999, three percent of IPOs were issued on-line).

328. *See* Walker, *supra* note 298, at 8.

329. The Federal Home Loan Mortgage Corporation ("Freddie Mac") is the "publicly chartered agency that buys qualifying residential mortgages from lenders, packages them into new securities . . . and then resells the securities on the open market." Downes & Goodman, *supra* note 29, at 140.

330. Walker, *supra* note 298, at 8.

331. Use of Electronic Media for Delivery Purposes, Exchange Act Release No. 33-7233, 60 Fed. Reg. 53,458 (Oct. 13, 1995).

332. *Id.* at 53,459 n.11.

333. A No-Action letter is "requested from the [SEC] wherein the Commission agrees to take neither civil nor criminal action with respect to the specific activity and circumstances." Downes & Goodman, *supra* note 29, at 281.

334. IPONET, SEC No-Action Letter [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, at 77,270-77,274 (July 26, 1996). IPONET, which was founded by Leo Feldman, a registered principal of W.J. Gallagher & Company, Inc., a securities dealer and underwriter, asked for and received no-action relief from the SEC in order to post notices of private securities offerings to previously qualified accredited investors on its password-protected website. *Id.* at 77,271-77,274.

335. *Id.*

336. Richard Walker, A Bull Market in Securities Fraud?, Address at the National Press Club 1 (Apr. 5, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch265.txt. The SEC has received over 1900 complaints

is the marketing of securities that are patently worthless or complete shams.[337] While the SEC has increased its surveillance and enforcement[338] of such fraud, its resources are insufficient to completely protect the investing public.[339] As noted above, numerous scams are marketed over the Internet, specifically targeting individual investors without the financial sophistication to properly evaluate the worthiness of such offerings.[340] The Internet provides fraudulent issuers with the means to instantly offer millions of potential investors a sham security and then disappear before the SEC has an opportunity even to recognize the existence of the offering. Just a few examples of other economically unmarketable securities recently offered on the Internet include investments in eel farms,[341] prime bank guarantees,[342] and even shares in a new country.[343] Additionally, legally unmarketable securities are being sold through the Internet. One issuer, who raised over three million dollars by selling unregistered securities in a gambling and lottery enterprise, failed to satisfy numerous regulatory requirements in order to legally operate such a business.[344] These are exactly the types of situations where, under the *Abell* and *Joseph* guidelines, it would be appropriate to grant private plaintiffs a presumption of reliance based on the fraud-created-the-market theory. Because of the wide-spread reach of the Internet, there is the potential for large numbers of investors to be defraud by such schemes, creating the distinct possibility of class actions. The fraud-created-the-market theory is especially suited to class actions brought under Rule 10b-5 of the Exchange Act.[345] Such

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regarding misrepresentation in selling a product in the last two years. Investor Complaints and Questions Continue to Rise, *available at* http://www.sec.gov/news/data.htm.

337. *See* Walker, *supra* note 336, at 3-4; Unger, *supra* note 326, at 3 (discussing offering frauds).

338. Unger, *supra* note 326, at 2 (noting that the SEC's 2000 budget was allocated an additional $12.5 million for the single aim of improving its ability to regulate the Internet). The SEC created the Office of Internet Enforcement in 1998 to perform surveillance and investigation of the Internet for securities fraud, in addition to coordinating regular sweeps on the Internet. Internet Enforcement Program, *available at* http://www.sec.gov/divisions/enforce/internetenforce.htm.

339. Walker, *supra* note 336, at 2, 5.

340. *Supra* notes 2-7 and accompanying text.

341. SEC v. Daniel Odulo, d/b/a Golden Waters Productions, Litig. Release No. 14591, 1995 WL 493347 (Aug. 7, 1995).

342. SEC Commissioner Laura S. Unger, Investing in the Internet Age: What You Should Know and What Your Computer May Not Tell You . . . , Address at the Association of Retired Persons National Legislative Council Annual Meeting 3 (Feb. 3, 2000), *available at* http://www.sec.gov/news/speech/spch342.htm.

343. SEC v. Lazarus R. Long d/b/a New Utopia, Litig. Release No. 16110 (Apr. 9, 1999), *available at* http://www.sec.gov/litigation/litreleases/lr16110.txt.

344. SEC v. Pleasure Time, Inc., d/b/a Telephone Information Systems, et al., Litig. Release No. 15178 (Dec. 6, 1996), *available at* http://www.sec.gov/litigation/litreleases/lr15178.txt.

345. *Supra* notes 179-80 and accompanying text.

securities are issued by parties, knowing that they are either economically or legally unmarketable, for the sole purpose of defrauding investors.

CONCLUSION

The fraud-created-the-market theory is both a valid and necessary presumption of reliance. It is a natural extension of Congress' goal in creating the Acts to protect investors and to maintain integrity in the securities market. A policy limited to full disclosure leaves a loophole for parties with purely fraudulent intentions. The fraud-created-the-market theory closes this loophole by easing the plaintiff's cumbersome burden of proving reliance in situations where actual reliance is irrelevant because of the defendant's plan to completely defraud the market. When properly applied, it does not create the feared investors insurance.

In 1988, before the Internet Age, the Supreme Court in *Basic Inc.* commented on how dramatically the market has changed since the enactment of the Exchange Act.[346] The Court stated, "[t]he modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences."[347] The Supreme Court foresaw the continued changes that the securities industry is undergoing and that flexibility in applying securities legislation will be necessary. The fraud-created-the-market theory will continue to be a necessary tool for plaintiffs in certain Rule 10b-5 causes of action.

346. Basic Inc. v. Levinson, 485 U.S. 224, 243-44 (1988).
347. *Id.* (citations omitted).